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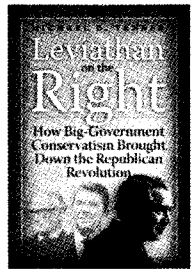


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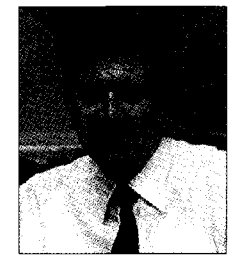
From the President

# The Cost of the Federal Government in a Freer America



BY RICHARD M. EBELING

In February, President George W. Bush submitted his proposed federal budget for the fiscal year that begins in October. It called for total government spending of over $2.9 trillion. The administration and the Republicans in Congress insisted that this budget reflected fiscal responsibility and the promise of a return to a balanced budget a few years down the road. The Democrats, on the other hand, declared the budget "dead on arrival" because it set the wrong priorities and was too harsh to the "neediest" in society.

What the two major political parties and the administration are debating is how much should be spent and on what. What none of them ask, or even seem to consider, is whether the federal government *should be* spending taxpayers' money on the vast majority of these programs and activities.

The late Senator Everett Dirksen is purported to have once quipped in the 1960s, "A billion here, a billion there, pretty soon you're talking about real money." In President Bush's budget it is the hundreds of billions to be spent here and there that add up to the real money. If we break down the President's budget we find the following planned expenditures: $919.1 billion on Medicare and Medicaid; $607.7 on Social Security; $510.8 on other nondefense spending; $602.9 on defense expenditures; and $261.3 on net interest owed on the national debt.

"Entitlement" spending (Medicare, Medicaid, and Social Security) would absorb 52.6 percent of the budget; other nondefense spending would consume 17.6 percent; defense spending would take 20.8 percent; and interest payments on the federal debt would be 9 percent.

Among cabinet-level departments there would be the following increases in spending: Veterans Affairs, 13.3 percent; State, 12.9 percent; Health and Human Services, 8.7 percent; Labor, 7.9 percent; Housing and Urban Development, 7.1 percent; Treasury, 6.9 percent; Energy, 5.4 percent; Defense, 4.1 percent; Agriculture, 3.6 percent; and Transportation, 2.7 percent. These increases are all above the current rate of increase in the Consumer Price Index.

The administration estimates that total federal revenues from all taxing sources would be $2.662 trillion. The deficit for the fiscal year, therefore, would come to $239 billion, or about 8.2 percent of expenditures.

It is estimated that $1.247 trillion dollars would be collected in individual income taxes; $927.2 billion would come from Social Security, Medicare, and related receipts; $314.5 billion would be obtained from corporate income taxes, $68.1 billion from excise taxes, $25.7 billion from estate and gift taxes, $29.2 billion from customs duties and fees, and $50.6 billion from "miscellaneous" sources of tax revenue.

With a U.S. population of about 301,150,000, a federal budget of $2.901 trillion means a per capita federal burden on every man, woman, and child of about $9,634. With an estimated 112,250,000 American households, this means each household would bear a burden, on average, of $25,845. (This does not count the burden of state and local taxes.)

Some of the more "strict constructionist" conservatives in Congress occasionally say the federal government is "out of control" and far beyond the "original intent" of the Constitution. But virtually none challenges what the federal government does, nor do they propose abolishing those departments, bureaus, agencies, and activities that clearly are not "strictly" enumerated in the Constitution.

And most certainly no one in the halls of power asks the fundamental question: What should be the functions of government if its only purpose is understood to be securing each individual's right to life, liberty, and property?

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According to the 1868 *World Almanac* (the first year it was published), the responsibilities of the federal government were far fewer than today, even in the aftermath of the Civil War. There were only seven executive departments: Treasury, State, War, Navy, Interior, Attorney General, and Postmaster General.

Let's suppose the federal government's responsibilities today were only as extensive as they were in 1868. And just for the sake of argument, let's suppose each of these departments and branches of government only cost half of what President Bush proposes, since the federal arm of government would be far less intrusive in people's lives. What would be the cost of government and the tax burden on the American citizenry?

Making the roughest of estimates from the President's budget, the federal government would cost only about $622 billion. (This includes the $262.3 billion in net interest payments on the federal debt. If this debt did not exist, the hypothetical budget would be around $360 billion.)

Again roughly speaking, the imagined budget would mean a tax burden of only $2,065 per capita. And the average tax imposed on households would be about $5,540. In other words, the burden would be almost 80 percent less than what President Bush wants. Also, this would assure a balanced budget in the *coming* fiscal year, not in some politically manipulated and uncertain future.

What makes the real difference between this imagined budget and the one actually submitted? Of course, the welfare state! All the departments, bureaus, and agencies that have been added to the federal government since those far more laissez-faire days of the mid-nineteenth century have been the product of the interventionist and redistributive state.

In 1887 J. Laurence Laughlin, who founded the economics department at the University of Chicago, warned:

> Socialism, or the reliance on the state for help, stands in antagonism to self-help, or the activity of the individual. That body of people is certainly the strongest and the happiest in which each person is thinking for himself, is independent, self-respecting, self-confident, self-controlled, and self-mastered. When a man does a thing for himself he values it infinitely more than if it is done for him, and he is a better man for having done it. . . . If, on the other hand, men constantly hear it said that they are oppressed and downtrodden, deprived of their own, ground down by the rich, and that the state will set all things right for them in time, what other effect can that teaching have on the character and energy of the ignorant than the complete destruction of all self-help? They think that they can have commodities which they have not helped to produce. They begin to believe that two and two make five. . . . The danger of enervating results flowing from dependence on the state for help should cause us to *restrict the interference of legislation as far as is possible*, and should be permitted only when there is an absolute necessity, and even then it should be undertaken with hesitation.

Laughlin added, "The right policy is a matter of supreme importance, and we should not like to see in our country the system of interference as exhibited in the paternal theory of government existing in France and Germany."

Unfortunately, America did import the theory and policy of political paternalism from the collectivist trends then growing stronger in Europe. They became the basis and rationale for a far bigger government in the United States beginning in the Progressive Era in the early decades of the twentieth century and accelerating in the New Deal days of the Roosevelt administration in the 1930s. They have continued ever since under both Democrats and Republicans.

But the ideological wind is out of the sails of the interventionist welfare state. It continues to exist in America and indeed around the world not because most people really believe that government can solve all their ills and make a paradise on earth, but out of pure political inertia. Our task, however daunting it may seem at times, is to offer a new vision of a free society that can once again capture the excitement and confidence of our fellow citizens. When that is accomplished the size and cost of government, over time, will be reduced accordingly.



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Perspective

# Extortion in Port Chester

The least appreciated form of tyranny in the United States goes by the names "redevelopment" and "government-business partnership." While everyone knows about the threat of development-oriented eminent domain, thanks to the 2005 Supreme Court decision in *Kelo v. New London*, local tyranny goes much deeper than the "mere" taking of property in order to give it to another private party.

A case out of Port Chester, N.Y., illustrates the danger. In 1999 the Village of Port Chester and the development firm G&S Port Chester agreed to embark on a $100 million 27-acre redevelopment project in which dilapidated buildings would be torn down in favor of stores, a movie complex, and other amenities. Under the agreement the Village government gave G&S sole authority to obtain properties in the project area both through negotiation and eminent domain. Only G&S can build there, and any profits from the project belong to the developer.

This smells bad enough already, but it gets worse because Bart Didden, who owns property that is partly in the project area, wants to build a CVS drugstore. The local Village planning board said okay, but under the redevelopment agreement G&S has veto power. Rather than vetoing the plan, however, G&S made Didden an offer: You can build your store if you fork over $800,000 or make G&S a 50 percent partner.

When Didden balked, G&S threatened to have his property condemned and to build a Walgreens drugstore there instead. Didden called the developer's bluff, and before he could blink, the Village moved to condemn his land. Didden went to federal court to stop the abuse, but the case was dismissed at the district and appellate levels because, the courts said, he filed too late. The Institute for Justice (IJ) tried to get the case before the U.S. Supreme Court, but the Court declined to take it. The *Christian Science Monitor* thought Didden's case could be the "next big test of the power to seize property." But it is not to be.

Before the Court refused the case, IJ lawyer Dana Berliner had said that a victory for the Village "would



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mean that every redevelopment area in the country would be a Constitution-free zone. Any taking, no matter how private, would be OK as long as it was in those areas." Afterwards she added, "This abuse will only grow worse until the courts do their job and set some limits on government's power of eminent domain."

Village officials defend G&S, maintaining that in return for developing the area, the developer was assured all the profits from the project. If Didden were allowed to proceed, the agreement would in effect have been changed. "A contract is a contract," says Mark Tulis, attorney for the Village.

There's just one problem: *Didden was not a consenting party to the contract*. The Village made commitments on behalf of Didden and his property without his permission. So G&S's ability to threaten condemnation if Didden refuses to pay up is an outrage, all the more so because it was bestowed by the government.

This sort of thing is all too typical. Local planning entities and politically connected developers have been running roughshod over property rights for years. It has become so common that it's hardly controversial for most people. It's just the way things are done. Most people think economic development couldn't happen without such practices. (See Steven Greenhut's August 2006 *Freeman* article, "Central Planning Comes to Main Street," and George Leef's November 2005 *Freeman* article, "*Kelo v. City of New London*: Do We Need Eminent Domain for Economic Growth?")

There's a word for what's going on in Port Chester, and Didden does not shrink from using it: "My case is about extortion through the abuse of eminent domain; it is about payoffs and government run amok. It took me years of hard work to buy that property, pay off my mortgages and really feel like I own it. How dare the Village of Port Chester and this developer threaten me in this way."

How dare they, indeed?

★ ★ ★

A student wonders if the presence of illegal immigrants mitigates the negative effects of the minimum wage. His professor, Howard Baetjer, responds.

Property rights, which are so critical to the progress of society, are anything but static. They undergo change in response to many factors, including technology. Andrew Morriss explains as he continues his series on property in America.

The "Swedish model" has long been thought of as a blueprint for the welfare state. But if that's what it is, Sweden must have failed to apply it during its years of economic progress. Waldemar Ingdahl sets the record straight.

One of the most consequential of recent laws passed by Congress to regulate the economy is the Sarbanes-Oxley Act of 2002. Enacted in response to the Enron collapse and other corporate scandals, the new law has been praised as the key to good corporate conduct. That's not how it's working out, Barbara Hunter writes.

The Food and Drug Administration has been under fire simultaneously for keeping life-saving drugs off the market and letting pharmaceutical companies market dubious products. Larry van Heerden sifts through the facts and proposes an alternative to top-down regulation.

Reports of "old" Europe's economic recovery are greatly exaggerated. So says Norman Barry.

Our columnists serve up a copious intellectual feast: Richard Ebeling analyzes the proposed federal budget. Lawrence Reed describes a Polish hero. Burton Folsom identifies another killer New Deal program. Thomas Szasz wonders when people will come to their senses about the "drug war." Walter Williams points out that the minimum wage hurts minority teenagers most. And Richard McKenzie, reading assertions that the minimum wage does no harm to unskilled workers' total compensation, objects, "It Just Ain't So!"

This month's book reviewers weigh volumes on big-government conservatism, environmental solutions, foreign aid, and welfare-state liberalism.

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# Raising the Minimum Wage Will Do No Harm? It Just Ain't So!

BY RICHARD B. MCKENZIE

President Bush and the Democratically controlled Congress had all but done it. As this went to press, they were on the verge of hiking the federal minimum wage, which has not budged since 1997. The minimum wage has likely risen by 70 cents, or to $5.85, an hour by the time these words are read. The minimum will jump to $7.25, or by a total of $2.10, an hour over the next two years.

Supporters of the proposed minimum-wage hike of all political stripes have, once again, fallen prey to a common delusion that government can, with a wave of its magic legislative wand, suppress competitive market forces in any way deemed desirable.

Nevertheless, any actual increase in the minimum wage will likely have a minimum effect on employment and overall earnings of covered workers. This is partly because the federal legislative wand has never proved very potent.

A couple of hundred econometric studies on the employment effects of minimum-wage increases over the last four decades show that modest hikes (say, 10 percent) tend to have little to no employment impact, *even among the most vulnerable worker group*—teenagers (with teenage employment falling no more than 3 percent and very likely less than 1 percent of those employed with a 10 percent wage hike).

As usual, in the short recent congressional debate both opponents and proponents of minimum-wage hikes pushed totally wrongheaded arguments, because both groups fail to realize that while mandated wage laws contain competitive pressures exerted on *money wages*, they do not materially suppress the overall force of labor-market competition that low-wage workers have to confront. With a higher minimum wage, competitive pressures will simply be felt in nonmoney-wage dimensions of employment contracts.

Proponents have argued (as did Steven Pearlstein in the *Washington Post*, January 10) that the proposed wage hike will have "minimal" to no effect on employment, partly because the higher wage will inspire a productivity jump among covered workers and/or the higher wage costs will be passed along to consumers in higher prices. If competitive forces have these effects, should we not also expect those same forces to pressure firms to contain their labor costs in all ways possible, including curbs in nonmoney forms of compensation provided workers, which can dampen firms' need for productivity improvements and product price increases?

Opponents of minimum-wage hikes (for example, Gary Becker and Richard Posner writing for the *Wall Street Journal*, January 26) will magnify as best they can the employment effects of any mandated wage hike, not realizing that the available findings of little to no employment effects from modest minimum-wage increases actually support their more fundamental position, that government should not try to tamper with Mother Nature—or competitive market forces.

Menial workers are paid little not so much because of employer greed as because of their low productivity *and* competitive pressures in both their own labor markets and their employers' product markets. Those competitive pressures do not subside when the minimum wage is increased. If the wage hike gives rise, initially, to more workers looking for jobs than there are jobs available

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(as both sides agree will happen), employers can respond simply by taking away fringe benefits *and* increasing work demands, thus largely reducing, if almost negating, the cost effects of the mandated money-wage increase. (This explains the minimal measured effects of any minimum-wage hike.) A number of research studies support such an outcome:

- Writing in the *American Economic Review*, Masanori Hashimot found that under the 1967 minimum-wage hike, workers gained 32 cents in money income but lost 41 cents per hour in training—a net loss of 9 cents an hour in full-income compensation. Several other researchers in independently completed studies found more evidence that a hike in the minimum wage undercuts on-the-job training and undermines covered workers' long-term income growth.
- Walter Wessels found that the minimum wage caused retail establishments in New York to increase work demands by cutting back on the number of workers and giving workers fewer hours to do the same work.
- The research of Belton Fleisher, L. F. Dunn, and William Alpert shows that minimum-wage increases lead to large reductions in fringe benefits and to worsening working conditions.
- Mindy Marks found that workers covered by the federal minimum-wage law were also more likely to work part time, given that part-time workers can be excluded from employer-provided health insurance plans.
- If the minimum wage does *not* cause employers to make substantial reductions in nonmoney benefits and increases in work demands, then an increased minimum should cause (1) an increase in the labor-force-participation rates of covered workers (because workers would be moving up their supply of labor curves), (2) a reduction in the rate at which covered workers quit their jobs (because their jobs would then be more attractive), and (3) a significant increase in prices of production processes heavily dependent on covered minimum-wage workers. Wessels found that minimum-wage increases had exactly the opposite effect: (1) participation rates went down, (2) quit rates went up, and (3) prices did not rise appreciably—which are findings consistent only with the view that minimum-wage increases make workers worse off.

## Quantifying the Harm

With the money-wage hike and the reduced benefits, workers can be left worse off since the fringes and slack work demands taken away were provided in the first place because workers valued them more highly than the wages forgone for those benefits. Given the findings of his own as well as other researchers' studies, Wessels deduces that every 10 percent increase in the hourly minimum wage will make workers 2 percent worse off. This means that the presumably enacted $2.10, or 39 percent, minimum-wage increase can be expected to leave affected workers 8 percent worse off in terms of their overall "payment bundle" (including the money and nonmoney benefits of employment).

Employers facing strong competition will be forced to cut out workplace advantages to neutralize as much as they can (but not totally) the imposed money-wage cost increase. That will be necessary just to avoid losing market position to those employers who respond to competitive pressures by cutting out the costly extras. The workers whose jobs are most at jeopardy from any minimum-wage hike will be that small group of (truly desperate) workers whose only form of compensation is their money wages and who are working as hard as humanly possible.

The sad outcome from any minimum-wage hike is that both employers' and employees' welfare will be undercut. The better news is that the forces of market competition will ensure that the damage done by politicians will be smaller than critics of minimum-wage hikes have heretofore recognized.

Congress and the President, of course, are doing what is politically expedient. In the process they have once again failed to heed a lesson that many market-oriented economists have always taught indirectly, if not directly, in their writings: You can't fool Mother Nature, and there is little constructive point in trying to fool competitive markets, even with the best of intentions.



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# At the Intersection of the Minimum Wage and Illegal Immigration

BY HOWARD BAETJER

This question from a former student named Blake addresses the interaction of two hot political issues: "I remember in class that raising minimum wage is a bad thing to do. My question to you is, since illegal immigrants don't get paid minimum wage most of the time, does that aid in bringing down wages and creating a positive outcome for the economy?"

My answer was an uneasy yes and no. Any positive or negative outcomes are not for "the economy" as such, only for people. And the people in the economy are all of us, including the illegal immigrants. Illegal immigration may reduce the overall harm done by increases in the minimum wage, but better all around would be legal immigration and no minimum wage. Let's sort the issues out to see why.

First, Blake is correct that "raising minimum wage is a bad thing to do" because it does most harm to the least-advantaged among us. The benefits of a higher minimum wage are much easier to perceive than the harms. The benefits go to all workers who keep their jobs when the minimum is raised (without losing enough hours' work to decrease their incomes). They get a pay raise. These are the benefits that minimum-wage advocates focus on.

The harm done by the minimum wage is harder to perceive. The key to understanding it is the insight that nobody will pay an employee more than that employee's value to the business, at least not for long. If you are the employer and you believe that a low-skilled young person contributes about $6 of value to your company every hour, you'll be willing to pay that person up to $6 an hour. If an increase in the minimum wage then forces you to raise his pay to $7 an hour, you'll lose a dollar an hour if you keep him on. You'll have to lay him off.

The harm done by the minimum wage is harder to perceive. The key to understanding it is the insight that nobody will pay an employee more than that employee's value to the business, at least not for long.

Minimum-wage laws that force wages above the rates that would be freely negotiated in the market throw people out of work. This is a fundamental conclusion of economic reasoning, supported by the vast majority of scholarly studies of the minimum wage.

What kinds of workers, exactly, get thrown out of work? Suppose you employ a number of low-skilled young people at $5.15 an hour at your fast-food restaurant along with your higher-skilled managers. Some of these minimum-wage workers are more skilled, more responsible, or more experienced than others. Now suppose the minimum wage is raised to $7.25 an hour (as is being discussed in Congress as of this writing). Suppose you calculate that the higher wage rates you now must pay will make it unprofitable for you to keep your restaurant open during the same hours at the same prices. You'll have to either raise prices or shut down at the least-busy times of day, or some combination of the

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two. Whatever course you take, you'll reduce the number of hours' work for your employees. If you raise prices, you won't have as many customers, so you'll need fewer workers to serve them. If you reduce your hours of operation, you won't need your workers for as long.

Whose hours will you cut back? Those of the more-skilled, more-responsible, more-experienced workers? Probably not. You will cut back on the hours of, or perhaps lay off altogether, the least-skilled, least-responsible, least-experienced workers. Those who will have the hardest time getting another job, those who most urgently need the experience of an entry-level job, are the ones who get laid off.

Who else is harmed by the minimum wage? In our example, your managers and other more-skilled workers are also harmed by having their hours cut back. Unlike the least-skilled workers who have nowhere else to go when they lose their entry-level jobs, the more-skilled workers can find work elsewhere. But when they do, it will be at jobs that don't pay quite so well or otherwise are not as attractive to them—or else they would have chosen to work there instead of at your restaurant in the first place. Thus these workers are hurt even if they keep the same number of work hours.

While some workers lose their jobs (or enough hours of work to reduce their total incomes), other workers get paid more. We can't know which effect is greater without unknowable details about the lives and values of the different workers. But clearly the law harms the most disadvantaged—the very workers that minimum-wage advocates claim to want to help. This is the overlooked human tragedy of the minimum wage.

What about consumers (who are rarely considered in public commentary on the minimum wage)? Consumers who would like to eat at your restaurant during off-hours are harmed because now you are closed at those times. If you stay open the same hours but charge higher prices, consumers are hurt by the added expense. The output of your laid-off workers is denied them, and the output of the higher-skilled workers and managers driven into other work elsewhere is not worth as much to consumers as the lost output of your restaurant would have been—that's why the wages paid in those alternative jobs are lower than at your restaurant.

Here is the clear harm done to "the economy"—the people in society—taken as a whole: Because of the legal minimum wage (or its increase) valuable productive resources are forced into idleness. In our example, lower-skilled workers, better-skilled managers, the restaurant, and its equipment are all idled (or, in the case of your managers, diverted to less-valuable production), even though workers, owners, and customers all would prefer that those resources be at work in your restaurant. Productive effort and mutually beneficial exchanges that would have occurred don't occur. Society overall is poorer as a result.

> It is incorrect to think that illegal immigration as such is beneficial for the economy. It is better than no immigration at all, but compared to free immigration, it is worse.

## Illegal Immigration's Effects

How might illegal immigration reduce this harm?

Some immigrants, here illegally to begin with, are also willing to work for illegally low wages. When they do, they help produce goods and services that would otherwise go unproduced, or be produced only at greater cost. Their willingness to work for below-minimum wages thus reduces costs and increases output for consumers. This is probably what Blake had in mind when he referred to illegal immigration "bringing down wages and creating a positive outcome for the economy." In our example, after the legal minimum wage is raised, you might be able to find illegal immigrants willing to work for less than the minimum. If so, you will be able to keep your prices down and/or stay open later in the evening. Your store, equipment, and workers would stay in productive use; consumers would benefit.

But not everything about this scenario is positive even if illegal immigration does keep actual wages and costs down closer to an appropriate, market-determined level. In certain cases it would be better still for "the economy"—for the people in the economy—to



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have certain illegal immigrants paid *higher* wages than they would receive while immigration is illegal.

Some illegal immigrants who would earn higher wages in a free labor market find themselves trapped in jobs that pay below minimum wage. Why? Because they are afraid that if they leave those jobs for others that pay more, they might be reported and thrown out of the country. This hurts consumers: it would be better to have those immigrants working at the higher-paying jobs instead, because the output of those jobs is more valuable to consumers. Let us imagine, for example, a talented carpenter who can find little work in his own country—let's call him Juan. Suppose Juan sneaks across the border, or gets himself smuggled into the United States, to work as a manual laborer at a landscaping company for below minimum wage. Though it is not much to us, that wage is much higher than he can earn in his home country.

Now suppose that a local carpenter needs an assistant whom he would pay $15–20 an hour. Juan's greatest value in the economy would then be to work as the carpenter's assistant. This is clear because the local carpenter's willingness to pay him $15 or more an hour shows that people in the community value at that amount the carpentry Juan might do each hour. For Juan's manual labor, by contrast, people are willing to pay only $6 or $7 an hour. Juan is worth more in the economy as a carpenter.

Nevertheless, when immigration is illegal Juan might well choose to do the less-valuable work because he is afraid of being deported. Perhaps the man who smuggled him in has an agreement with the head of the landscaping company and Juan worries that if he moves to a better job the smuggler might report him. Or he might worry that working as a carpenter's assistant would put him at risk of being turned in by other carpenters who would resent his competition. Or the state might require a license for carpenter's assistants, for which only legal immigrants may apply.

For these kinds of reasons illegal immigrants often hold jobs in which their work is less valuable than elsewhere. All such cases represent a clear loss to society because even though the illegal immigrants' willingness to work for below minimum wage keeps wages and costs down in the markets for lower-skilled labor, their talents are sadly wasted. They would be better used providing services that people in the community value more.

## Reducing Production

Just as minimum-wage laws reduce society's overall wealth by decreasing the production of valuable goods and services, so also do laws hindering immigration. Both interfere with the labor market's essential function of directing human talent—what the late, great economist Julian Simon called "the ultimate resource"—to their most valued uses.

In answer to Blake, then, yes, it may be that illegal immigration helps to reduce the damage done by minimum-wage laws and minimum-wage increases. But no, it is incorrect to think that illegal immigration as such is beneficial for the economy. It is better than no immigration at all, but compared to free immigration, it is worse.

The problem with illegal immigration is not that it's immigration, but that it's illegal. The proper immigration policy for a free and prosperous nation is open borders—free immigration for all people who will live and work peacefully. Liberty, including liberty to move peacefully about the planet, cannot justly be infringed. It is a basic human right, and it promotes economic well-being.



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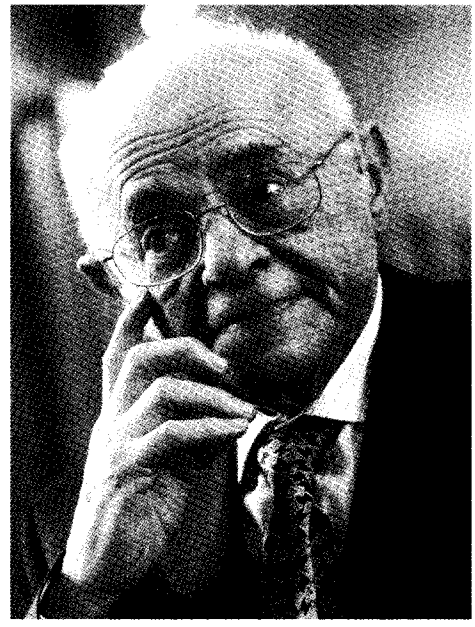
# A Tribute to a Polish Hero

BY LAWRENCE W. REED

One year ago the world lost a gifted science-fiction writer and critic of totalitarianism when Poland's Stanislaw Lem died in March 2006. Lem was best known internationally as author of the classic *Solaris*—twice adapted for the silver screen—but the majority of his fiction featured damning allegories against the suppression of the human spirit. Bruce Edward Walker, cultural critic and editor of *MichiganScience*, says Lem "skillfully dissected the 20th century's foolhardy efforts to create utopias by stifling individuality and economic freedoms."

Lem ranks high in the Polish pantheon of independent thinkers and dissidents, any list of which would be long and distinguished. Poland's role in the historic unraveling of the Soviet empire was pivotal by any measure. And while world leaders from Pope John Paul II to Ronald Reagan played a part, the audacity of the homegrown resistance is a story that is still underemphasized to this day.



Stanislaw Lem (1921–2006)

In November 1986 I spent nearly two weeks in Poland with the anti-communist underground. This was five years after the Warsaw government declared martial law and threw many pro-freedom activists in jail. It was still many months before the big changes of 1989 that would liberate Eastern Europe from the communist yoke. One night during my visit I met in a private home with a half-dozen underground printers. They were eager to impress me with examples of many great pro-freedom books they had illegally translated, printed, and distributed throughout the country. I asked, "Where did you get the paper to publish all this stuff?"

"From two places," replied a young man named Pavel. "One, we smuggle it in from the West. Two, we steal it from communists." When I asked him to explain the second source, he revealed that many of the workers in the communist government's publishing houses were sympathetic to the resistance. When those workers saw the opportunity, they smuggled the paper out or even printed resistance literature on the government's own printing presses.

The impressive stack of illegally printed books those printers showed me included works by great scholars of liberty from the West—Hayek, Mises, Rothbard, to name just three. I later raised $5,000 for the underground to translate, publish, and distribute Milton Friedman's classic *Free to Choose*, a copy of which I proudly display today in a glass case in my study. But there were books, essays, and ideas by native Poles that the underground took risks to disseminate as well. Stanislaw Lem was one of them.

Born in 1921, Lem survived both Nazi occupation and Soviet rule in the town of his birth, which was known alternately as Lwów in free Poland, Lvov in the Soviet Union, and Lviv in modern Ukraine. His father was a doctor, and Lem was poised to follow in his footsteps until Hitler's invasion in 1939. He was forced to work as a mechanic but became a crack saboteur: "I learnt to damage German vehicles in such a way that it wouldn't be discovered," he said.

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Lem resumed his medical studies following the war, eventually finishing his degree in Cracow in 1946. He intended to pursue a career in theoretical biology, but abandoned his plans rather than adhere to the since-discredited practices of Soviet geneticist Trofim Lysenko. He turned to writing, only to have his first novel, *The Hospital of the Transfiguration*, banned by communist censors for nearly a decade.

By 1951 Lem realized that his only hope of publishing was to mask his views as allegorical works of science fiction. State apparatchiks in charge of expunging subversive works from the public square were too stupid to appreciate his subtlety, but Polish intellectuals and many ordinary readers knew full well what the underlying message was. What Lem did with a wrench to German vehicles, he later did with pen and ink to the communist state.

Lem used his considerable intellect (he reportedly had an IQ of 180) and writing skills to parody Soviet and Polish leaders and subtly convey the torments of communist life. He is seen as in the same mold as satirical fantasists Jonathan Swift, George Orwell, and Franz Kafka. In the estimation of many who took great risks to criticize the Soviet and allied Eastern European regimes, his work sits comfortably alongside such anti-totalitarian classics as Arthur Koestler's *Darkness at Noon* and Alexander Solzhenitsyn's *The Gulag Archipelago*. His writings have been translated into at least 40 languages, have sold nearly 30 million copies, and span a wide range from screenplays, short stories, and mystery novels to more serious matters of philosophy, cybernetics, and the nature of intelligence itself.

*The Astronauts*, published in 1951, was followed by *Time Not Lost*, a fictionalized account of Nazi occupation of Poland. *Return from the Stars*, published in 1961, presented a world devoid of "the hell of passion, and then it turned out that in the same sweep, heaven, too, had ceased to be. Everything now is lukewarm. . . ." This bland reality, noted reviewer Marilyn Jurich, "reduces the possibility of individuals accepting personal risks," resulting in "a monotone, denatured safe world at the cost of direct experience in a nature that is open, unknown, risky; a world where wild animals have disappeared along with human emotion and initiative. Individuals have few means left to test physical capacity or mental endurance."

## Nightmarish Conformity

The short story "The Thirteenth Voyage," in the collection *The Star Diaries*, depicts the totalitarian urge at its most invasive. In that story "The Angelicans," a group of social engineers, determine that all human foibles can be solved by collectivization, producing a nightmarish, stagnant conformity. Having lived through collectivism of both national socialist and communist varieties, Lem knew his subject well.

Lem published his last collection of fiction in 1988, before the collapse of the Berlin Wall and the subsequent implosion of the Soviet Union. He told interviewer Istvan Csicsery-Ronay, Jr., in 1985: "The literature of the 20th century has lost its battle, or at least finds itself in retreat. . . . The tales of refugees from totalitarian countries reduce themselves to an exhaustive catalogue of social and psychological suffering that such systems treat their citizens to. These books cannot pick their readers up, and the lessons they teach are not pleasant. One could say that the job of literature is not primarily to entertain, move, and cheer us up, but as [Joseph] Conrad said, to 'bring the visible world to justice.' Well, in order to bring this world to justice, it is first necessary to understand it with one's intellect, to appreciate the wealth of its diversity."

Another Polish dissident, Stefan Kisielewski, was once jailed for an eloquent three-word sentence: "Socialism is stupidism." As a rule, dictators understand the power of ideas better than most people, which is why they often make it illegal to simply harbor a certain thought or give that thought expression in ink on paper. Thankfully, courageous men and women like Stanislaw Lem found creative ways around evil regimes—a key reason those very regimes now exist only in the history books.



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# The Economics of Property Rights

BY ANDREW P. MORRISS

Property rights play a critical role in a wide range of economic institutions. From understanding why owners are generally better stewards of property than renters to finding ways to resolve environmental problems, property rights are at the center of the analysis. It is unsurprising, therefore, that economics offers important insights into property rights. The economic approach is not the only way to think about property, and economic analysis is often misused, but it is an important part of understanding why property rights are so important to liberty and human progress. In particular, economics can help us understand two fundamental aspects of property rights: how they change and the types of problems they solve.

A simple example illustrates the evolution of property rights in land. The basic form of property in land in the United States is called the fee simple absolute. The owner of a fee simple absolute has the maximum extent of rights possible in the land under the law; most privately held American land is in this form.

An owner of a fee simple absolute in a plot of land in 1800 and an owner of a fee simple absolute in the same plot in 1900 had different sets of rights because of changes in the law. Between 1800 and 1900 the federal government abandoned a claim it had in mineral rights in private land. Most national governments in 1800 claimed a share of any minerals produced from any land within their boundaries. (Indeed, most national governments still make such a claim today.) Although American law was not completely clear on the subject in 1800, many thought that the federal government had inherited the English government's claim of a share of mineral rights, and such claims were asserted by the federal government a number of times during the first part of the nineteenth century. By 1900, however, the United States had effectively abandoned its general mineral-rights claim and recognized that private landowners with fee simple title had property rights to both the surface and subsurface of their land. Indeed, the U.S. government went further and through a series of laws in the 1860s and 1870s, culminating in the General Mining Law of 1872, recognized individual claims of ownership of mineral rights and surface rights by those who discovered valuable mineral deposits on federal land.

Now compare the rights held by today's owner of this land with the rights held in 1900. Over the past century or so, various governments took important parts of the property-rights bundle from many landowners. Local governments passed zoning laws, reducing landowners' freedom to use their property as they see fit. State governments adopted a wide range of land-use restrictions. Some, such as Florida, adopted statewide land-use planning programs that imposed major restrictions on how property could be used. Others simply increased taxes on land. The federal government significantly reduced landowners' rights through regulatory statutes such as the Endangered Species Act and the assertion of jurisdiction over a wide range of "wetlands" under the Clean Water Act. As a result, an owner of a fee simple absolute in that same property today has many fewer rights than the 1900 owner did.

At the same time, the rights that remain in that fee simple absolute have evolved in ways that make them potentially more valuable today through private efforts

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at rebundling rights. For example, one of the fastest-growing forms of property ownership today is ownership in communities in which a developer has rearranged the property rights through covenants, easements, and servitudes. One of the best known such communities is the town of Celebration in Florida, constructed by Disney. There restrictions in the deeds govern a multitude of details of the houses constructed on the property. Houses must conform to a particular architectural style, have front porches and white window hangings fronting the street, be painted a color from a specified range, and so forth. While the deeds to the properties Disney sold were notable for the number and detail of restrictions, they were by no means unique. In fact, millions of Americans now own property in which they paid a premium price to receive a deed with many more restrictions on use than was common even 30 years ago. Why?

In Celebration, Florida, there are restrictions in the deeds that govern a multitude of details of the houses constructed on the property, including architectural style.

The solution to this seeming paradox of paying more for less lies in the relative values of the rights lost and gained. Property owners in Celebration did not just give up property rights; they also acquired negative rights in their neighbors' property.

A homeowner in Celebration is limited in her choice of colors for her house—but so are her neighbors. A homeowner in Celebration is limited in the color of blinds she can hang in the windows facing the street—but so are her neighbors. The success of Celebration in boosting property prices in the development over the prices for property in surrounding areas that lack the restrictions tells us that property owners are more concerned with limiting their neighbors' ability to create aesthetic annoyances than they are with maintaining their own ability to do so. Reallocating the property rights among the property owners in Celebration increased the value of the bundle of rights each person purchased because it added rights worth more (the ability to prevent an aesthetic disaster down the street) than those it took away (the ability to create one's own aesthetic disaster).

Not everyone wants to live in Celebration, or even in a community with fewer restrictions, such as the one in Yuma, Arizona, where my parents live and all houses must be painted a shade of sand color. Enough people do, however, that property owners and entrepreneurial developers have discovered that they can increase the value of some properties by incorporating such restrictions into their deeds. Property law makes such transactions possible by providing a mechanism for embedding such reallocations in deeds and so binding future purchasers of the property. It also provides a way out of deed restrictions that become obsolete, as a future entrepreneur could change or abolish restrictions by reuniting the parcels benefited and burdened by them.

There's an important difference in how property rights changed in these examples. In the expansion of property rights to include subsurface rights between 1800 and 1900, rights became more secure as the result of government's limiting its claims against individuals. In the rearranging of rights involved in creating developments with a particular aesthetic, private entrepreneurs used contracts and deeds to increase their property values through voluntary transactions. In the contraction of property rights from 1900 to the present through regulatory statutes, however, interest groups used the power of the state to forcibly redistribute property rights. (Anyone who doubts the "forcibly" portion of the preceding sentence need only speak to one of the landowners criminally prosecuted for violating federal endangered-species or wetlands laws and regulations.) Unfortunately, the value created by the combination of property rights and voluntary transactions all too often makes property rights a tempting target for expropriation.



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## Property Rights Evolve

The first key economic insight is thus that property rights are not static. They evolve. How does this evolution work? As a type of property becomes more valuable, people are willing to invest more in efforts to define rights to it. Property rights thus naturally evolve in response to changes in technology, changes in costs, changes in tastes, new discoveries, and other changes in individuals' preferences. A critical role in this evolution is played by entrepreneurs who identify opportunities to increase value by rearranging property rights.

How do property rights evolve? It is useful to think about five different ways in which they regularly change:

(1) The subject of property rights changes, making new things property that were not previously considered property.

(2) The bundle of rights changes, making it possible to divide property rights in new ways and trade those rights.

(3) The method of establishing property rights changes, making the cost of establishing property rights different.

(4) The method of protecting property rights changes, making the cost of securing property rights different.

(5) The method of stealing property rights changes, making property rights more or less secure.

Property rights can evolve to include new subjects. A classic example is the development of water rights in the nineteenth-century American west. Settlers from the more humid east found that the water-law institutions they brought with them, derived from English law and custom, were inadequate. Eastern water law gave riparian rights to landowners adjacent to bodies of water. These rights generally included the right to use water but not to diminish its flow for downstream users. In the west, where water was scarcer, however, the right to divert water for irrigation or mining was valuable. Western states and territories quickly recognized a doctrine of prior appropriation, whose essentials came out of the practice of early miners and farmers in the region. Under prior appropriation, water users had the right to divert water, with users' rights ranked in the order in which it was originally appropriated.

Unfortunately, western water rights subsequently became the subject of a massive resource grab by the federal and state governments. Wyoming initiated the process by asserting a claim of state ownership to all surface water in its 1889 state constitution and placing the state engineer's office in charge of water allocations. The federal Bureau of Reclamation built massive water projects across the west with tax dollars, further distorting water rights. The combination made western water rights less secure and limited their evolution in response to changes in technology and demand for water. Today, however, many states have loosened their control of water rights and are beginning to allow markets to emerge.

Rights also evolve into different bundles through voluntary transactions that benefit both parties. As discussed earlier, entrepreneurs in the United States discovered that reallocating the rights to make aesthetic decisions about the appearance of homes could increase the value of properties in some cases. Other examples include sale of easements to neighbors that allow an adjacent property owner to guarantee the preservation of a desirable view and conservation easements that allow a property owner to sell development rights to a preservation group while continuing to use his land.

The method of establishing rights also evolves in response to demand. Creation of an easy-to-use title system increases the value of all property, facilitating transactions by making it inexpensive to determine who owns a particular piece of land. The development of title insurance facilitated property transactions by reducing the risks for buyers. More recently, the securitization of mortgages in the United States has vastly increased the financial resources available to prospective property owners by making it possible for investors to buy diversified portfolios of mortgages. What all these examples share is that they are the result of entrepreneurs identifying an opportunity for profit and using the tools provided by the law to create a means of earning that profit.

Finally, property rights evolve in response to changes in how they can be defended. Property owners often play a critical role in physically defending their rights, as anyone knows who has seen the broken-glass-topped walls, gates, and razor wire routinely used by property owners in countries where land is vulnerable to invasion. New technologies can repeat the role of barbed



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wire on the American Great Plains, making it possible to cost-effectively control access to resources that cannot be safeguarded today. For example, in the not-too-distant future we may see a combination of GPS and DNA-testing technologies provide a means to create property rights in migratory sea animals, such as whales.

The evolution of property rights is a remarkable phenomenon. In the United States and elsewhere, positive developments have produced better-defined, more secure, and more valuable bundles of rights over time. That evolution has occurred as the result of individuals' seeking to fulfill their own plans, to earn profits, and to use their property to serve their own needs. In short, the voluntary transaction-driven evolution of property rights is a Hayekian spontaneous order.

At the same time, however, there have been value-destroying, liberty-restricting developments in property law. The widespread adoption of central-planning methods for land-use control, the seizure of private property to redistribute it to favored interest groups masquerading as "economic development," and regulatory restrictions on property owners in pursuit of special interests' agendas, as has happened with laws such as the Endangered Species Act and Clean Water Act, are the result of the combination of an unconstrained state and the attraction of the wealth individuals create through the trade made possible by property rights.

## Property Rights Solve Problems

There are two fundamental problems solved by property rights: (1) how to exchange goods in the course of trade and (2) the commons problem.

The problem of how to exchange goods in trade is a serious one, although not one we often consider today. If goods belonged to whoever happened to pick them up, there would be little reason for me to trade with you. I could simply wait until you fell asleep or were distracted and take the goods without giving you anything in return. Even if you and I agreed between ourselves, or if all the people in our neighborhood or even our town agreed on who owned what, we would still not be close to unlocking the potential value made possible by a system of well-defined property rights.

To take but one example, many new businesses in the United States are started by entrepreneurs using their homes as collateral. If a bank could not be sure who owned the property offered as collateral, it would not be willing to lend the money. Similarly, if the bank thought that it could not collect on the collateral, it would be unwilling to lend. When banks can rely on clear titles, however, they are willing to advance money, holding the titles as collateral. When property rights are sufficiently clear and markets well-enough developed, bundles of security interests in land can be combined and turned into new investment securities. These securities then make it possible to expand the pool of money invested in real estate, and so enabling even more, even cheaper loans. The economic power of property rights in such cases is so extraordinary that they almost seem to be alive with energy. Indeed, Peruvian economist Hernando de Soto refers to property in societies where rights are so poorly specified that using it as collateral is impossible as "dead capital" because it cannot be used to produce new value in this way.

This critical feature of property rights—that they permit trade and so permit the creation of wealth—is central to the economic case for them. It provides the solution to some thorny philosophical issues as well. Philosopher David Schmidtz suggests that the solution to the problem of the Lockean Proviso—the requirement that "enough and as good" be left for others in a just system that includes original appropriation—is that allowing the original appropriation produces more for those who come after by permitting trade to take place. In his essay "The Institution of Property," Schmidtz points out that "Philosophers are taught to say, in effect, that original appropriators got the good stuff for free. We have to pay for ugly leftovers. But in truth, original appropriation benefits latecomers far more than it benefits original appropriators. Original appropriation is a cornucopia of wealth, but mainly for latecomers. The people who got here first never dreamt of things we latecomers take for granted."

The second important problem property rights solve is the tragedy of the commons. Made famous by Garrett Hardin in his 1968 article in *Science*, a tragedy of the commons occurs when there is no means to exclude others from a resource. Under these conditions, the resource will be overused to the point of destruction so long as each user gains more benefits than the costs he



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The commons is a problem only for societies that lack property rights.

bears as a result of his actions. In Hardin's example, villagers shared access to a common field. Each could put as many cattle on the field as he desired since no one had the right to exclude another. As a result, each villager added cattle so long as the last cow he added benefited him more than it cost him. Since a portion of the cost created by the additional cow was the reduction in grass available to the cows owned by others, no villager took into account the total cost to the village of the additional cows. Unsurprisingly in Hardin's example, the field ended up with so many cattle grazing on it that it was overgrazed and destroyed. All the villagers were worse off, yet no one had had an incentive to stop the overgrazing. Why?

Without the power to exclude, any grass left for tomorrow would be eaten by someone else's cow today. Even if the villagers had all recognized that there were too many cows on the land, no one would rationally agree to reduce his herd because any grass "saved" would be eaten by someone else's cow.

As Hardin recognized, in a passage rarely cited by those eager to use his work as an excuse for state intervention, the commons is a problem only for societies that lack property rights. The tragedy, Hardin declared, is solved by "private property, or something formally like it." And in fact there was no tragedy of the commons in medieval English common fields, the case Hardin used as his example, precisely because there were property rights in them, known as "stinting," that limited the ability to add animals. Stinting rights were based on the amount of property in the private fields each villager held.

By making it possible for a property owner to gain from good stewardship, private property creates an incentive to invest in maintaining and improving resources. Just as important, if someone is not engaged in good stewardship, whether due to ignorance, indolence, or idiocy, private property rights make it possible for someone who is able to engage in good stewardship to offer a premium over the value of the property to the current owner. By buying the property and improving its management, the new owner can generate enough income to pay the higher price. (Of course, not every owner will sell when offered more money than he is getting from his property, but many will.)

## Government-Caused Problems

Economics can also shed light on how governments can cause problems with property rights. Two problems are particularly acute today. The first is that governments may impede efforts to create tradable property rights by attempting to steal resources for themselves. The second is that governments may fragment property rights into so many small bundles that the cost of reassembling them into useful arrangements is too high to be worthwhile.

The problem of predatory states is as old as the state itself. Simply taking property without compensation is of course possible, but predators that engage in such naked aggression kill the goose that lays the golden egg. More common are efforts to chip away at property rights on the margin, transferring specific rights from property owners to favored interests. For example, local governments often attempt to condition construction permits on grants of easements or restrictions on use of



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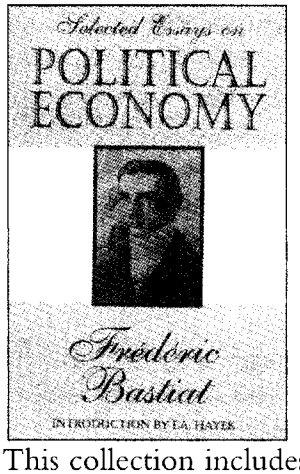
the property in question. Similarly, "regulatory takings" are a major area of concern, as property rights become entangled in a web of regulatory restrictions. Unfortunately, the American courts have been even less protective of property rights in the face of regulatory takings than they have been with respect to outright takings.

The problem of fragmentation of property rights is particularly acute in countries attempting to privatize state-owned property. In some instances, rather than decide to whom to award a particular property, officials simply gave it to everyone. As a result, there were multiple "owners" able to veto any particular use of a property. Professor Michael Heller termed this the "tragedy of the anticommons" after observing it in post-Soviet Russia. Heller wondered why so many Moscow storefronts were empty while businesses occupied kiosks on the sidewalks in front. He discovered that the reason was that granting of rights to the former employees of the stores so fragmented ownership that reaching an agreement on a use of the property was virtually impossible. The tragedy of the anticommons is a creature of the state. Overcoming it is largely a matter of preventing fragmentation of property rights in privatization efforts.

In his history of property rights and civilization, *The Noblest Triumph,* Tom Bethell concludes that private property makes possible liberty, justice, prosperity, and peace. Secure property rights make liberty possible because they fence off a private domain out of the reach of the grasping hand of the state. They make justice possible because property owners reap the rewards and suffer the losses caused by their actions, linking reward to merit. They make prosperity possible because they allow trade. Finally, secure private property rights make peace possible because they enable each individual property owner to pursue his or her own plan, free from the interference of others and without interfering with others.


## Selected Essays on Political Economy

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# The New Sweden

BY WALDEMAR INGDAHL

The European Social Model is being heavily discussed in Europe. Some still laud it, but its problems are obvious, with low economic growth, an aging population coupled with "pay-as-you go" pension systems, and widespread persisting unemployment.

In Sweden we have already solved this problem; we discarded the social model and replaced it with a free-market system.

This announcement may come as a big surprise to many in Europe, especially after former Prime Minister Göran Persson's article in a *Newsweek Special Issue*, where he exalted the Swedish model for being both fair and competitive.

But in fact, from his election in 1996 until his defeat last September, Persson, former leader of the Social Democratic Workers' Party, radically transformed what had been perceived abroad as the Swedish model. What we believe about a model might not be the truth but solely a projection of our ideological predilections and dated assumptions. (Persson was succeeded by Fredrik Reinfeldt, leader of the "center-right" Moderate Party.)

Initially the Swedish model meant the 1950s' full employment and low inflation, something that was achieved through competitive industries, relatively low taxation (lower than the U.S. level at the time), and unregulated markets.

The admired Swedish model was in fact abandoned in the 1970s, precisely when it gained its international fame and admiration. Then the world's highest tax rates were introduced, together with interventionism, particularly in social policy and the labor market. An ill-fated attempt to introduce the radical "next step" toward Yugoslav-style trade-union-controlled socialism ended the decade. The expansion of government was an effect not the cause of the system's previous success. The result of this expansion was the dismal crisis of the early 1990s, when the Swedish Central Bank vainly tried to link an overvalued krona to the European Exchange Rate Mechanism and then protect it with 500 percent interest rates.

The rest of the decade consisted in the slaughtering of many of the Swedish model's most sacred cows by the Social Democratic Party, but the process was executed in silence. It was not the conscious and explicit change of policy effected by Britain's New Labor. Rather, it was a change of course in practice but not in theory or in the government's rhetoric. The gap between word and action was wide.

> Sweden has discarded the social model and replaced it with a free-market system.

When looking at Sweden today and comparing it to the rest of the EU, one is struck by its relatively free-market approach. It ranks 21st and 24th, respectively, in the latest Heritage Foundation and Fraser Institute indexes of economic freedom.

For a long time Sweden has been favorable to free trade, which is understandable since 60 percent of GDP derives from it. For a time in the early 1990s Sweden abolished all farm subsidies and had one of the most deregulated agricultural sectors in the world, before unfortunately being forced to re-regulate when entering the European Union's (EU) Common Agricultural Policy.

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In 1996 Sweden deregulated its market for electricity, allowing private competition in distribution. Today, half the nuclear power plants are owned by a German corporation.

Telecommunications, postal services, and public transportation have largely been deregulated, opening up new markets. The state monopolies have been abolished, and the telephone company has been partially privatized.

The introduction of a voucher system has opened up a market in which parents have a high degree of choice over where to send their children to school.

Health care has largely been opened to private alternatives, thanks to the doctors' and nurses' labor unions. In fact, one of Stockholm's largest emergency hospitals, St. Göran's, is a private company listed on the stock exchange.

Sweden has a comparatively low corporate tax rate of 28 percent. The process for opening a business is relatively straightforward, ranging from one week to a couple of months. Sweden presents few barriers to foreign investment, maintaining restrictions only in some limited national-security–related sectors. Most commercial banks in Sweden are privately owned and operated. Banks are allowed to offer a full range of services, and foreign banks have access to the sector. Few working days are lost to strikes. It is easy to close down factories and move investments abroad. There is no legal minimum wage. Unlike in other European countries, retailers do not have their hours regulated. In 2005 the government abolished inheritance and gift taxes. The Swedish Competition Authority has forcefully reacted against local politicians who restrict full competition.

Sweden has high immigration per capita and was, along with the Britain and the Republic of Ireland, the only original EU member not to impose restrictions on workers from new member countries.

The pension system has been reformed from the problematic "pay-as-you-go" formula to a program funded according to the performance of the economy. In the fully funded system all Swedes choose investments for their pensions. If the economy does not grow, pensions will be low, and there are mechanisms that prevent the system from going bankrupt.

Granted, it is an easy task to become a paragon of liberalization in today's Europe. But it shows that what many Europeans favorably refer to the Swedish model is not applied anymore in Sweden.

These changes, which would have been seen as radical if enacted in the "Anglo-Saxon" market model, have paid off for Sweden, permitting a 2006 GDP growth forecast of about 4 percent. Inflation was lowered to an average 1.4 percent last year.

Granted, it is an easy task to become a paragon of liberalization in today's Europe. But it shows that what many Europeans favorably refer to as the Swedish model is not applied anymore in Sweden. The remnants of the old model—high income taxation (60.3 percent on average), the high value-added tax (25 percent), the regulated labor market, and the insufficiently reformed social-redistribution systems—are the problematic areas in the Swedish economy, not its bold vanguard.

If someone had predicted in the 1980s that Sweden would follow the social-democratic model set by France or Germany, I as a libertarian would have agreed. Today I can say that Europe should embrace the Swedish model.



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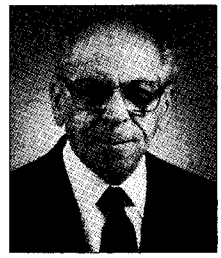

# On Not Admitting Error

BY THOMAS SZASZ

According to a September 2006 report in the *New York Times*, Afghanistan's opium harvest has increased almost 50 percent from the year before and reached the highest levels ever recorded. Antonio Maria Costa, head of the United Nations Office on Drugs and Crime (sic) explained: "It is indeed very bad, you can say it is out of control. . . . The Taliban had distributed leaflets at night, inviting farmers to increase their poppy cultivation in exchange for protection. . . . I am pleading with the government to be much tougher. A new high-security prison block would be inaugurated in a few weeks. We have place for 100 people and I am asking the government to fill it within six months."

History is a chronicle of people clinging to erroneous ideas authenticated as religious or scientific truths. Max Planck (1858–1947), one of the greatest physicists of all time, observed: "A new scientific truth does not triumph by convincing its opponents and making them see the light, but rather because its opponents eventually die, and a new generation grows up that is familiar with it."

History is a chronicle of people clinging to erroneous ideas authenticated as religious or scientific truths.

In the natural sciences the lifetime of belief in false truths tends to be brief. In contrast, beliefs in false truths in human affairs—in custom, religion, politics, and law—typically linger for decades, centuries, even millennia. "[H]ow can we agree," declared Mikhail Gorbachev, "that 1917 was a mistake and all the seventy years of our life, work, effort and battles were also a complete mistake, that we were going in the 'wrong direction'? No . . . it is the socialist option that has brought formerly backward Russia to the 'right place.' "

Gorbachev sought to put a human face on the inhuman visage of communism, and the more he failed, the more he insisted that he was on the right track. American drug prohibitionists—Democrats and Republicans alike—seek to cast the ignoble war on drugs into a noble, therapeutic rhetoric, and the more they fail, the more they insist that they are on the right track.

Coercive world-savers have always been blinded by their reformist zeal. Communists denied the importance of man's need for private possessions, a propensity they perceived as "property abuse," and called individuals and institutions that catered to that need "capitalist exploiters." Drug prohibitionists deny the importance of man's need for mind-altering chemicals, a propensity they perceive as "drug abuse," and call individuals and institutions that cater to that need "narco-terrorists" and "narco-states."

The opium trade is said to constitute one-third or more of Afghanistan's gross domestic product. People who grow and sell opium, like people who grow and sell olives, are engaged in agriculture and trade not terrorism. Using explosives and herbicides to destroy crops—especially the crops of faraway people with different traditions and religions—*is* terrorism.

The story of the trade in alcohol in America and the West is familiar, and so also are the medical and social effects of drinking. In the United States alone, intoxicated drivers cause an estimated 17,000 traffic deaths per year, one every 30 minutes. Twenty percent of all traffic fatalities are due to driving while under the influence. The same day that the *New York Times* ran its report on opium cultivation in Afghanistan, it also ran a story about the use of alcohol in the United States.

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The entire state of Wyoming, said the writer, is like "a small town with long streets. . . . The open space means room to roam and a sense of frontier freedom. It also means that on any given night, an unusually high percentage of young people here are drinking alcohol until they vomit, pass out or do something that lands them in jail or nearly gets them killed." Rosie Buzzas, a Montana state legislator and part-time alcohol counselor, tells the reporter:

> We're a frontier culture, and people say, "I work hard and I'll be damned if I'm not going to have a beer or two on the way home." . . . There's a church, a school, and 10 bars in every town. It has never been hard for young people to get alcohol in Montana, Ms. Buzzas said, in part because many parents think it is a rite of passage for children to drink. "There are plenty of adults who tell me, 'What's the big deal? Kids just have to learn to drink.' " . . . Not long ago, three children, ages 9, 11 and 12, died of alcohol poisoning in an isolated town in Montana, but the deaths did little to change attitudes.

Customs and traditions are more powerful than laws, guns, and herbicides. We have our customs, other people have theirs. "Why," asks an unidentified Afghan, "does the government tell us to stop growing opium when it's doing nothing about alcohol use and prostitution? Opium is not mentioned in the Koran, but alcohol and prostitution are."

A scholar on Iranian culture reminds us that before Qajar's period (which began in the late eighteenth century), "opium was deeply integrated into Iranian social and daily life. People consumed opium each morning in order to be in a good mood to go to work. . . . Opium functioned in Iranian society the way that wine does in French society."

We define certain goods, in particular opium and cocaine, as presenting irresistible temptations, especially to Americans; persecute the tempters and regard their oppression as the protection and promotion of public health; call the people who justify and promote the persecution "medical scientists" and "lawmakers"; and honor the individuals who engage in the mayhem and murder integral to the enterprise as heroes in a noble "war on drugs."

## Taxpayer-Funded Cathedral

Afghans who grow poppy are criminals, and Americans who use heroin are patients suffering from a "diagnosable no-fault disease" we call "substance abuse." To combat this "plague," we have erected and consecrated a taxpayer funded-cathedral, the National Institute on Drug Abuse. NIDA's official "Mission" is:

> to lead the Nation in bringing the power of science to bear on drug abuse and addiction. Recent scientific advances have revolutionized our understanding of drug abuse and addiction. The majority of these advances, which have dramatic implications for how to best prevent and treat addiction, have been supported by the National Institute on Drug Abuse (NIDA). NIDA supports over 85 percent of the world's research on the health aspects of drug abuse and addiction. . . . NIDA research is a critical element to improving the overall health of the Nation.

Under a subhead, "NIDA for Teens: The Science Behind Drug Abuse," we read: "By abusing drugs, the addicted teen has changed the way his or her brain works. . . . These changes cause addicted drug users to lose the ability to control their drug use. Drug addiction is a disease. . . . There is no cure for drug addiction, but it is a treatable disease." In short, government scientists teach American children that the use of some drugs is a "disease" they cannot control and doctors cannot cure, which only lifelong submission to the government anti-drug priesthood can keep in "remission." "Our goal," NIDAs mission statement concludes, "is to ensure that science, not ideology or anecdote, forms the foundation for all of our Nation's drug abuse reduction efforts."

Could all this deception, self-deception, effort, and expense be the practical consequence of a simple conceptual error consecrated as truth?



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# Punishing the Innocent: The Sarbanes-Oxley Act

BY BARBARA HUNTER

If any person or any group had set itself the task of creating a law whose purpose was to destroy the American free-enterprise system, it could not have done a better job than what has been produced by the Sarbanes-Oxley Act of 2002. The law is predicated on the principle that all companies are inherently evil and untrustworthy and thus must be governed from above by benevolent bureaucrats with both dictatorial and second-guessing powers.

What brought on this draconian law? In all likelihood, anyone born before 2000 who has been living in anything other than a deep cave is familiar with the name Enron, which is emblematic of corrupt corporate dealing and disastrous losses to employees and stockholders. It is significant, however, that the fraudulent acts of the principals of that company were prosecuted under existing law and within the then-existing rules of the public stock exchanges. It follows that new laws were not in fact necessary either for punishment of the malefactors or for prevention of further criminal acts. What was needed, however, at least from the view of members of Congress, was some evidence of their "doing something"; that is, not a legal solution but a political solution.

What then has Sarbanes-Oxley accomplished? So far, the history of the law has been an endless list of compliance requirements that (with few exceptions) have been of no productive benefit but that have inflicted enormous losses on the affected companies both in dollars and time.

Sarbanes-Oxley imposes such draconian demands that everybody's money is affected—including yours. The full text of the law essentially turns much of the nation's corporate governance on its head. Its effect is to place a new government agency—the Public Company Accounting Oversight Board (PCAOB)—in charge of the financial, accounting, reporting, procedural, and security operations of every corporation registered with the Securities and Exchange Commission (SEC). The Board is authorized in effect to look over every corporation's shoulder, decide whether the firm "complies" with the Board's own interpretations of law, and even punish the principals (such as the chief operating officer, chief financial officer, and chief information officer) with fines and, incredibly, incarceration for such infractions as failure of sufficient supervision. As noted in a "white paper" (informational document) prepared for a prominent software company, Sarbanes-Oxley "significantly increases penalties . . . with maximum jail terms that now exceed the penalties for crimes such as armed robbery, assault with a deadly weapon and negligent homicide."

Congress can pass laws pretty much at will, with little concern for the associated costs on those who must comply. It should come as no surprise that former government employees are valued, even sought after, by companies forced to deal with the new bureaucracy. For many companies, compliance skills now trump an understanding of corporate goals.

Sarbanes-Oxley empowers the Board with the most authoritarian powers imaginable. It can conduct investigations and disciplinary proceedings at will and can impose fines and otherwise discipline companies and the accounting firms they employ. In effect, it is prosecutor,

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judge, jury, and executioner. The notorious Section 404 requires that any "process" that could in any way affect financial results be audited and reported and, further, that the chief executive of the company must personally accept responsibility for the accuracy of all reports, under penalty of up to 20 years in prison. Exhaustive procedures required have entailed thousands of hours of work and expenditures in the billions of dollars. Because these requirements affect all publicly traded corporations, large and small, the law has had the perverse result of according large companies an unfair advantage over their smaller rivals, which must devote a larger percentage of their time, money, and human assets to obeying the law.

To add insult to injury, the Board is permitted to make any changes it wishes, which places companies in the position of forever trying to hit a moving target. The changes issued last November, eliminating some of the minutely detailed auditing requisites, were widely hailed as good news. Unfortunately, this does not take into account that both the companies and the auditing firms had already instituted these procedures at enormous cost in money and computer-design talent, and thus would be unlikely to expend even more of the same to undo these efforts. (This is explained further below.)

The law prohibits auditors from providing any other services, such as bookkeeping, financial information-systems design and implementation, appraisal or valuation services, fairness opinions, or other advisory services. The result is that auditors must report whatever may be amiss but are forbidden to advise the company how to correct it and thereby comply. Also thanks to the new law, audit continuity will be a thing of the past, because an accounting firm can provide audit services for no more than five years. And in a provision that sets up the Board as final arbiter of corporate America, it is authorized to prohibit national securities exchanges and associations from listing any stock from a corporation that fails to meet its audit rules.

According to the Board's rules, every e-mail and even every instant message must be preserved permanently, giving rise to a whole new industry offering products (both hardware and software) that can store almost inconceivable quantities of data. One effect is likely to be that more communications, especially simple questions or comments, will be made by telephone or in person. The perverse effect is to make information less available.

## Field Day for Law Firms

Sarbanes-Oxley has contributed mightily to the demand for lawyers at all levels of government, as well as for legal assistance for the companies themselves. To make things even worse, the stock exchanges (NYSE, ASE, and NASDAQ), at the behest of Sarbanes-Oxley, have mandated that the majority of company directors be "independent"; that is, directors can have no material relation to the firm itself, either directly or indirectly, within the previous five years. It appears the requirement for director independence would exclude anyone who knows anything about the company.

Sarbanes-Oxley has contributed mightily to the demand for lawyers at all levels of government, as well as for legal assistance for the companies themselves.

The accounting firms that haven't already been sued out of existence have more work than they can handle. However, the law is certainly doing corporations, and by implication their shareholders, no favors. The now-overburdened larger accounting firms can cherry-pick the most lucrative clients, leaving the other companies to find whatever they can among the second-string firms.

If Sarbanes-Oxley has been difficult for publicly listed companies, it has been positively sunshiny for consultants and producers of software dealing with sales, financial reporting, and document storage. It is all but impossible for corporations to comply with the various rules, or even to determine whether they have complied, without the purchase of pricey software. Trade publications and websites are replete with advertisements for products to assist in both complying and testing compliance. Consulting services have been raking in



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abundant revenue based in part on the sheer difficulty of knowing how to meet requirements.

In addition to the quandary faced in locating independent auditors, the hefty filing fees embodied in the new law, similar to the other expenses detailed above, have hit small companies especially hard.

The hope that the law's requirements would eventually provide payback in more effective company management once the initial measures were put in place has been illusive for most firms. This effort and expense is especially galling to the majority of companies, which have striven throughout their existence to maintain the highest standards of business ethics. For them Sarbanes-Oxley has been an endless series of repetitions of what they already knew and were already doing in principle, if not in precise form.

But the costs are tremendous. According to CNNMoney.com last year: "A recent study conducted by the Securities Industry Association estimated that the cost of compliance has nearly doubled in the past three years to an estimated annual total of more than $25 billion in 2005, up from $13 billion in 2002." Note that the costs were supposed to go *down* with time.

The law's toll on time, talent, and productivity has affected virtually every publicly listed company. It isn't bad enough that the actual productive activities of companies have been delayed to the detriment of both profitability and competitive advantage. Once they actually get started on the postponed work, the Sarbanes-Oxley hammer is wielded anew. Company projects, especially those involving information technology and other computer-related activity, must now document the same type of internal controls as are mandated for the company as a whole. The effect on project life-cycles in many cases has been little short of disastrous with regard to meeting deadlines, which are the heart of profitability.

## Effects of the Data-Retention Rules

The requirements of retaining all data (every change, every correction, every previous version) in unerasable form has created an information behemoth that is not only massively expensive to create and run, but is also far more difficult to search and otherwise use than anything required heretofore. If one multiplies the size of such documentation by the number of companies affected by the law, it becomes evident that no matter how massive a bureaucracy may be created, there is close to zero possibility that any of this will benefit companies, shareholders, or the public.

With Sarbanes-Oxley bureaucrats watching everyone in corporate America, there can be no doubt that companies are practicing defensive management. The chairman of a large software house has commented, "We might have killed the goose that lays the golden egg. . . . You're mitigating every possible risk that can be conceived. Risk didn't use to be a bad thing." This person has suggested that, as a result, the biggest opportunities for private equity companies over the next ten years will be in China and India.

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In light of the foregoing, it may seem attractive for publicly listed companies simply to go private, and in fact the rush to do so has become a torrent—almost 200 companies as of mid-2005. However, it may not be either as simple or as helpful as it might seem. There is a significant possibility that even privately held companies may come within the Sarbanes-Oxley sway in the future. While on the surface this may seem remote, it should be borne in mind that all incorporated companies are subject to many state and federal laws, not just publicly listed ones. In this case, the PCAOB has been delegated enormous powers by Congress, and at least so far, most of those powers have not been challenged either for legality or constitutionality.

In 2004 the full force of the law took effect for foreign firms listed on U.S. exchanges, and the result has been an unmitigated disaster. Bearing in mind that other countries, as well as the EU, already have their own requirements, Sarbanes-Oxley has only heaped more burdens on the backs of foreign entities. According to the law, a foreign company listed on a U.S. exchange



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must meet all the Sarbanes-Oxley requirements if its shareholders include at least 300 Americans (even if they are merely invested indirectly through funds). Thus we see the phenomenon of U.S. law being enforceable on non-U.S. companies. As noted in a French-language paper directed to U.S. readers:

> The largest European conglomerates want to leave Wall Street but are having a hard time making this move happen. The French Association of Privatized Industry, a powerful group of corporate heads, has just joined their German, British, Greek, Dutch, Italian, Austrian, Swiss and Polish counterparts in an effort to persuade the Securities and Exchange Commission (SEC), the federal regulatory agency of the American securities market, to liberate them. . . . In other words, these corporations are trapped, held captive by their American shareholders, whose interest is protected above all else. As of 2002, or more specifically, since the Sarbanes-Oxley Law was passed . . ., this law has become increasingly repressive and costly to foreign owned companies.

It is indeed sad that foreign firms now view the U.S. financial markets, which were once the shining example of freedom and opportunity in the world, as something from which to be "liberate[d]," "allowed to leave," but are "trapped," "held captive" by "repressive" U.S. laws. How far we have come! Some foreign firms have already decided to do the obvious: They are buying out U.S. shareholders.

The other effect of the demands on foreign firms (which certainly should have been understood and anticipated) is that their new listings on U.S. exchanges have been reduced almost to zero. As a *Wall Street Journal* editorial succinctly expressed it: "In 2000, nine out of every 10 dollars raised by foreign companies through new stock offerings were done in the U.S. . . . [L]ast year [2005] not one of the top 10 initial public offerings (IPOs) measured by market capitalization was registered in a U.S. market."

## Is There Hope for Meaningful Change?

What has Sarbanes-Oxley accomplished? The answer is that it is just what would be expected of a law that was thrown together in great haste in order to "do something" about corporate malfeasance. Everyone pays the price, although, as noted, the price is larger for some.

By the usual standards by which the federal bureaucracy is judged, we might be tempted to throw in the towel and live with whatever Sarbanes-Oxley sends our way. There is, however, one faint ray of light: a legal challenge to the PCAOB from a Washington D.C.-based lobbying group that has joined with a small Nevada-based accounting firm. The basis of the suit is that the Board has government-like powers, such as the ability to levy fines, but little oversight by the government and thus is a violation of the Constitution's separation-of-powers clause.

It is also possible (though not likely) that the powers that be in Congress will realize that Sarbanes-Oxley has been one giant mistake brought about by misguided notions of where such qualities as honesty and ethics come from and will revisit the law and its reason for existing. It makes sense, but don't hold your breath.

The full extent of the destructiveness of this law may not be known for years. However, there is no denying that the bloom of creative possibilities has been replaced by the blight of endless fears of compliance violations. Will the Law of Unintended Consequences eventually be recognized and the effects ameliorated? Only time will tell.



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# Abolishing the FDA

BY LARRY VAN HEERDEN

The Food and Drug Administration (FDA) started out as a bulwark against snake-oil peddling. It has since swung back and forth between hostility and subservience to the drug industry. The FDA seems indifferent to the many deaths its own intransigence has caused and imperious when forced to defend its actions in court, resulting in a system that withholds life-saving drugs from the market, approves dangerous drugs, and denies everyone freedom of choice. The time has come to seriously consider abolishing the FDA.

Before 1992 the FDA was no friend of the drug industry. A 1980 General Accounting Office (now called the Government Accountability Office) report found that average drug-approval times in four other countries were six to 18 months shorter than the FDA's approval time. The report listed several reasons for delays in the United States: imprecise FDA guidelines, inadequate feedback to industry, lengthy reviews, incomplete drug applications, industry's slow rate of resolving deficiencies, congressional and consumer scrutiny of the drug-approval process, adversarial relationships between the FDA and industry, and the FDA's conservative approach to drug regulation.

A 1985 study by Dale H. Gieringer used mortality-rate reductions due to new drugs and casualties from new drugs to estimate the costs and benefits of FDA regulation. On the benefit side, Gieringer examined avoidance of drug disasters, such as the thalidomide tragedy of the early 1960s. He concluded that the benefit of FDA regulation compared to regulation in other countries was about 5,000 to 10,000 casualties avoided per decade. On the other side he concluded: "[T]he evidence suggests that regulatory delays in new drug approval may be quite costly, with casualties on the order of tens of thousands of lives per decade." On the other hand, according to one estimate, at least 106,000 people died from adverse reactions to FDA-approved drugs in 1994.

Over the last few years, exposés and articles on the FDA's cozy relationship with drug companies have appeared in a WGBH *Frontline* telecast, the *Boston Globe*, the *Washington Post*, and the *New York Times*. Beginning with the Prescription Drug User Fee Act of 1992, Congress required drug companies to pay up to half a million dollars to the FDA with each new drug application. The money was used to hire more reviewers to get drugs on the market more quickly. By 2003 over half the FDA's drug reviewers were paid with industry money and approval time for drugs had gone from over two years to less than six months. In fiscal 2006 industry money paid to the FDA was estimated to hit $382 million.

Meanwhile, the culture at the FDA had become industry friendly, which included a reluctance to challenge company claims about drug safety and effectiveness. The number of drug approvals became part of FDA employees' performance evaluations. FDA reviewers were pressured to approve drugs or soften the language in their reviews or on drug labels. It became common for researchers with ties to the drug industry to serve on FDA advisory panels. In 2005, in the wake of a series of drug-safety scandals and criticism from Congress, the FDA changed course again, issuing a flood of drug-safety warnings and slowing approval times for new drugs, prompting charges that the FDA was overreacting.

It's not hard to find cases of FDA abuse. A May 1995

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article in *Reason* discussed the case of Edwin Cohen, president of Barr Laboratories, who in 1989 testified before a congressional subcommittee about unfair treatment he had received from the FDA. Within hours FDA inspectors invaded Barr's facilities in retaliation. Barr sued the agency repeatedly for relief from harassment, while it worked tirelessly to close him down. The company was hit with a blizzard of minor inspection violations and delays in drug approval. Its share price fell to one-sixth its former value. Production on several product lines was stopped, and one-quarter of the company's employees were laid off. In 1993 Cohen was replaced by someone more agreeable to the FDA.

Articles in *Life Extension* (May 2001 and April 2002) describe the case of Durk Pearson and Sandy Shaw, who have been battling the FDA since 1994 for permission to sell folic acid with a label which includes the claim that the supplement is more effective than food sources of the vitamin in reducing the risk of neural-tube defects. The claim is well established in the medical literature and supported by the Institutes of Medicine and the National Academy of Sciences. In 1999, after years of bureaucratic delay, Pearson and Shaw sued the FDA. In an 11–0 decision, a federal appellate court ruled that the FDA had unconstitutionally suppressed this health claim. The FDA ignored the ruling and refused to authorize the claim, eventually issuing a regulatory ruling that it was "inherently misleading." Pearson and Shaw sued the FDA again to force it to comply with the court's previous ruling. In 2001 the court ruled that the FDA's health-claim standard was arbitrary and capricious. District Court Judge Gladys Kessler found the FDA's failure to comply with the earlier decision inexcusable and indicated she thought the plaintiffs and the public had been harmed. One survey showed that only 30 percent of women of childbearing age knew that folic acid reduces birth defects. By suppressing this information, the FDA had condemned thousands of babies to crippling birth defects.

For years the FDA refused to allow manufacturers to advertise the cardiovascular benefits of aspirin, despite clinical studies that supported the claim, resulting in the premature deaths of many thousands of people.

For years the FDA refused to allow manufacturers to advertise the cardiovascular benefits of aspirin, despite clinical studies that supported the claim, resulting in the premature deaths of many thousands of people. Regular aspirin use slightly increases the risk of stroke for some, and the FDA was worried that this risk would be overlooked by consumers. As Paul H. Ruben explains: "This behavior is typical of the agency. It invariably places a much greater weight on any potential harm from a drug than on any benefit."

## "Tough on Vaccines"

In the March 2006 issue of *Health Care News*, Henry I. Miller, former head of the FDA's Office of Biotechnology, argued that the risk-averse FDA "has been especially tough on vaccines. The agency has rejected evidence of safety and efficacy from European and Canadian vaccine approvals, prematurely withdrawn life-saving products from the market because of mere perceptions of risk, and set the bar for the testing of new vaccines almost impossibly high."

An April 2005 *Boston Globe* article on the collapse of a promising drug for lung cancer noted that challenges await the FDA as researchers continue to develop precision cancer drugs that benefit small groups of patients. These drugs will require a meticulous process of trial and error to match patients with the right drug. Pulling such a drug off the market could deny treatment to a subset of patients who have experienced remarkable recoveries with it. The article questions whether the FDA's approval process, which is geared toward drugs that work broadly across the population, can handle such precision drugs.

According to a 2002 WGBH *Nova* telecast, Dr. Brett Giroir isolated a compound, called BPI, which is an exact copy of a protein found in human white blood cells and which appears to neutralize the primary toxin responsible for meningococcal disease. Known also as meningitis, it is a rare affliction that strikes children and



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young adults, spreads rapidly, and can result in multi-system failure, lost fingers and limbs, deafness, permanent brain damage, or death. In a major trial for FDA approval, BPI seemed to reduce the number of limb amputations by 68 percent and increase survival by 25 percent, but the results were not considered statistically significant. Further trials to get the drug to market may take years. Giroir commented: "But it's very difficult to do a trial in a rapidly progressive disease like meningococcal disease, that by the time you get the patients many of them are dead, in a disease that's so rare, and in a disease where, I think, the rules are different."

Given the devastating consequences of the disease, doctors and parents might choose, on behalf of a child, to accept the risks of using BPI, since it is made from a protein that is part of the body's own defense system. However, the FDA thinks otherwise, and patients are left to suffer their fate without BPI.

In 2001 Abigail Burroughs, an honors student at the University of Virginia, died of cancer, the *Wall Street Journal* reported, "after she was stymied in her efforts to obtain new cancer drugs that her oncologist believed could save her life, but which were still in clinical trials." The Abigail Alliance was subsequently formed to help terminally ill patients gain access to promising drugs that have not yet been approved by the agency. In a lawsuit against the agency the Alliance argued that for terminally ill patients the restrictions on pre-approval availability of such drugs amount to a death sentence. The problem, the *Journal* argued in 2005, is that the FDA's oncology division is stuck with an outdated mindset that insists on placebo-controlled trials when newer statistical methods have been developed that could get promising therapies to terminally ill patients sooner.

Economists Daniel Klein and Alex Tabarrok have put their finger on the FDA's fatal conceit: Beginning in 1962 "the FDA began to act on the premise that it could establish authoritative knowledge of efficacy prior to experience and experimentation in actual market processes."

## False Sense of Security

If abusing patients by withholding drugs is a problem, so is the reverse: creating a false sense of security.

A *Consumer Reports* exposé in January 2006 found that tens of millions of people may have been exposed to the rare but serious side effects of a dozen common prescription-drug types in the United States during the 12 months ending in September 2005. Most of the drugs are used to treat conditions that are not usually crippling or life-threatening. However, these drugs can cause rare side effects such as heart attack, stroke, muscle breakdown, kidney damage, increased cancer risk, neurotoxicity, irreversible bone loss, increased asthma-related deaths, increased blood pressure, heart arrhythmias, psychosis, depression, and paranoia.

The FDA seems not to realize, as *Consumer Reports* argues, that drug companies: (1) sometimes withhold publication of studies that are disappointing or worrisome; (2) present study results to the FDA in ways that minimize safety concerns; (3) have often failed to conduct post-marketing studies needed to identify risks that often emerge after drug approval; and (4) engage in misleading advertising about safety and efficacy.

Yet people think the FDA is looking out for them.

FDA-defender Philip J. Hilts argues that such misconduct occurs when drug-company officials lose the moral sense of their actions as they act out their role of company and shareholder advocate, knowing that the FDA exists to play the (legally mandated) countervailing role of consumer advocate. Another factor that helps explain (though not excuse) such industry behavior is the "all or nothing" system that FDA gatekeeping perpetuates. Companies spend huge sums of money to shepherd a drug through FDA approval. The withdrawal of a single approved drug may affect a company's finances to the point of endangering its survival. In a system without such gatekeeping, where drugs were available along with all the information on risks and benefits, the market would sort the wheat from the chaff, dramatically lowering the financial stake in any single drug



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and reducing the temptation for drug companies to engage in fraud and deception.

## End the FDA

The first step to correct these problems is to abolish the FDA, stripping the government of the power to approve drugs (and medical devices) for the market or to remove them from the market. Any rule-making for disclosure and lawsuits for fraud should be devolved to the states.

Even if the FDA were omniscient, objective, and impervious to outside influence, it would be wrong to give it the power to withhold drugs from the market. The proper function of government is to protect individual rights and guard against fraud, not to restrict freedom of choice to protect people from their own ignorance. In fact, the FDA has shown itself to be imperious, subject to prevailing political winds, and indifferent to the thousands of deaths and injuries it has caused.

No amount of pre-market testing is sufficient to declare a drug safe and effective, which the FDA implicitly does when it approves a drug for the market. Other writers have pointed out that most adverse drug reactions are associated with prolonged use or heavy dosages, which don't arise in pre-market tests. Safety and efficacy depend strongly on individual factors, such as age, sex, genetic makeup, physical strength, condition, activities, allergies, diet, and disease combinations, which cannot be exhaustively examined in pre-market testing. *Consumer Reports on Health* noted in May 2005 that "even the best research of new therapies can't provide evidence of their long-term safety and efficacy." The best that can be done is to gradually accumulate information on the safety and effectiveness of a drug for varying populations, conditions, and circumstances as an increasing number of people consume it over longer periods. On the other side of the issue, withholding promising but untested (and possibly dangerous) drugs from patients who are at death's door and have no other options left, as the FDA routinely does, is unconscionable.

No amount of pre-market testing is sufficient to declare a drug safe and effective, which the FDA implicitly does when it approves a drug for the market.

In short, the FDA is wrong to withhold drugs from the market and wrong to put the government's imprimatur on them.

As early as 1985 Dale Gieringer recommended replacing FDA drug approval with patient package inserts and a "system of graded safety and efficacy ratings for unproven drugs." The wording used in such a graded system would be the subject of much debate. Here is an example of one such system for the safety of drugs that treat chronic diseases: **5**: "Consumed by millions of people for at least 5 years with no known problems; safe at recommended doses." **4**: "Consumed by millions of people for at least 4 years; considered safe at recommended doses except for certain populations or situations; see package insert for details." **3**: "Consumed by hundreds of thousands of people for at least 3 years; likely to be safe for most people except for certain populations or situations; see package insert for details." **2**: "Exercise caution; consumed by tens of thousands of people for at least 2 years; see package insert for populations or situations of known risk; unknown risks may be present." **1**: "Exercise extreme caution; although extensive clinical trials suggest this drug is safe, except as noted on package insert, it has been not consumed by enough people for enough time to clearly establish populations or situations where it may be harmful." **0**: "Little or no clinical testing; not widely consumed; presumed dangerous or fatal."

With such a rating system patients would be able to decide for themselves what level of risk they were willing to assume. As consumption of a particular drug increased and adverse reports failed to materialize, its rating would slowly rise.

A crucially important part of the drug market, and one at which the FDA has failed abysmally, is the collection, analysis, and dissemination of information on adverse drug reactions. In line with the government's typical command-and-control approach, busy physicians are supposed to report serious drug reactions to the FDA's MedWatch program without compensation for



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their time. As *Consumer Reports* noted in January 2006, the unsurprising result is that only 1 to 10 percent of such incidents are ever reported. Terminating the MedWatch program would allow superior private-sector initiatives to compete for this crucial function. One can imagine, for example, a health-information company paying a fee for every adverse drug report submitted as well as paying a premium for the first 100 reports of what turns out to be an adverse safety trend with a particular drug. Such a company would have little trouble finding a market among consumers and drug makers for its reports on drugs with safety problems.

In the late 1960s the FDA's Drug Efficacy Study examined the effectiveness of drugs that had been on the market before enactment of mandated pre-market drug testing. As a result of the study, around 300 drugs were removed from the market after being judged ineffective. In a market-driven system, such as the one proposed here, what would prevent the reappearance and wide consumption of worthless or even dangerous drugs?

One answer is private testing and certification of pharmaceutical drugs along the lines of what Underwriters Laboratories does for household appliances. Several writers have discussed how, in the absence of the current FDA monopoly, private firms could adequately and profitably fill this role.

However, a consumer's ace-in-the-hole for selecting the right drugs is the information available from reliable sources on the Internet and in print. *Consumer Reports* launched a free website (www.CRBestBuyDrugs.org) in December 2004 that allows consumers to check on the safety, efficacy, and price of drugs. The site offers reports on a dozen widely used drug categories, and new categories are added regularly. A *Consumer Reports* subscription website (www.ConsumerReportsMedicalGuide.org), "developed in collaboration with two prestigious organizations of international physicians and pharmacists, offers in-depth information for more than 60 common conditions and 900 prescription and over-the-counter drugs." Further, *Consumer Reports* publishes in hardcover the *Complete Drug Reference*, which provides information on more than 11,000 drugs.

Regulation advocates may protest: "What about the guy who consumes a drug without reading the package insert, consulting a medical professional, or looking at consumer websites or reference books? Shouldn't he be protected?" In short, no. Forcing all consumers to live by rules that cater to the least responsible individuals imposes huge costs on everyone else and ultimately fails to protect even the willfully ignorant. Something as simple as an aspirin may be a life-saving treatment under certain conditions (onset of a heart attack) and a death warrant in other circumstances (when combined with blood thinners). There is no alternative to becoming an informed consumer of pharmaceutical drugs. Ignorance is not an option.

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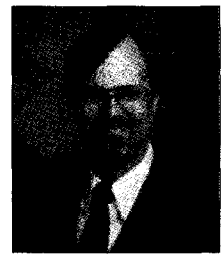

# Death by Public Works

BY BURTON W. FOLSOM, JR.

Almost all historians who write on the New Deal praise Franklin Roosevelt for using government to "solve" economic problems. Often, however, these historians only tell part of the story. One example is Roosevelt's vast public-works program. Here most historians wax eloquent on the dams built by TVA, the roads built by WPA, and the bridges built by FERA and CCC.

What the historians omit are the high taxes levied for these projects, the sometimes inept construction, and the behind-the-scenes politics where votes were traded to bring projects to the districts of powerful congressmen.

In some cases, New Deal programs not only failed, they also had death rates along the way. For example, there's the story of how Roosevelt sent World War I veterans to build bridges in the hurricane country of south Florida. At least 256 of these veterans died in FERA (Federal Emergency Relief Administration) camps in the Florida Keys, where they were sent in hurricane season with poor provisions and no plan of retreat or rescue.

FERA camp in the Florida Keys before the 1935 hurricane

The hurricane tragedy had its origin in a seemingly shrewd political decision by FDR. Unemployed veterans had been difficult to deal with. Ever since World War I they had campaigned in Congress for a special "bonus" for their service. In 1932 they put pressure on President Hoover by traveling to Washington, camping near the White House, and publicizing their demands for immediate payment for their wartime service. In a political blunder, Hoover decided to restore order among the rowdy veterans by sending Douglas MacArthur to confront them with cavalry, infantry, and six tanks. MacArthur decided to fire on them and disperse their camp—and photos blanketed the country showing the fleeing vets under fire from their own government. It was an election year, and when Roosevelt, then the Democrat candidate, saw the pictures and news reports, he reportedly told Felix Frankfurter, "Well, Felix, this will elect me."

Once in office, Roosevelt was determined not to repeat Hoover's mistake. Protesting veterans were not allowed to camp in Washington. They were directed to Ft. Hunt, Virginia, where they received offers to work in CCC (Civilian Conservation Corps) and FERA camps for $1 day plus food and shelter. Thousands of veterans accepted this offer, and Roosevelt sent them far away from Washington to camps in South Carolina and Florida. In December 1934, over 400 veterans were specifically transferred to the Florida Keys, where they were told to build bridges and roads that would help connect the 90-mile area from Miami to Key West.

Roosevelt's plan to export the contentious vets to Florida was clever, but Harry Hopkins and FERA officials in Washington tended to ignore the veterans once they were out of the capital. In Florida, Fred Ghent, the director in charge of the three camps of 400 veterans, had trouble, first, getting supplies and, second, enlisting help in preparing for hurricanes. The veterans were housed on low land, almost at sea level, in tents and flimsy barracks with poor food, inadequate supplies, and no water for bathing. They had no serious shelter to protect them from a hurricane or even high tides.

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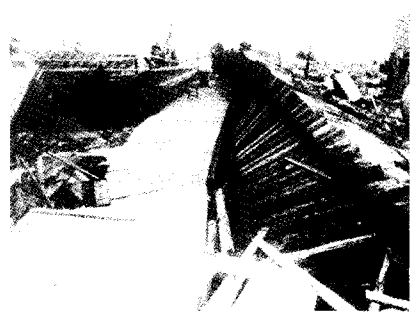
In April, three months before hurricane season, Ghent became concerned about the possibility of storms. He wrote FERA in Washington that "this area is subject to hurricanes" and "it is our duty . . . to furnish a safe refuge during a storm." Specifically, he requested that a solid two-story warehouse be built and arrangements be made with the Florida East Coast Railway to transport the men out of the Keys if a hurricane warning should occur. Ghent never received a response from Washington, and in the absence of instructions he took no action.

Trouble began in late August with weather reports of possible hurricanes coming toward Florida. On Sunday, September 1, at 10 a. m. a weather bulletin reached Key West warning of hurricane danger. Residents 20 miles west boarded their houses. The owner of the Hotel Matecumbe, who was within one mile of the veterans' camps, boarded his hotel as well. Ghent was in Miami. The following day he finally sent a Florida East Coast Railway train to the veterans' camps. The railroad was in receivership and many crewmen were unavailable because of the holiday weekend. That day a severe hurricane hit the Keys and knocked the train off the tracks before it ever made it to the FERA camps.



Destruction of the Florida East Coast Railway in the aftermath of the storm

When the full force of the hurricane hit the camps the carnage began. First-hand accounts among the few survivors reveal part of the horror: "There was a big wall of water—15 feet high—20, maybe," reported one veteran. It swept over those shacks and messed them up like they were match boxes." Another reported, "I heard William Clark holler that the roof [of the canteen] was coming down. We all started away in the same direction and the roof came down on us. It must have hit every one of us. After the roof fell all I could hear was the grunting and groaning of the boys. I never saw any of them after that."

After hours of the swirling hurricane one survivor said, "[B]odies were lying all over the roadway and lumber piled on them and some of them had holes in their heads." In the aftermath another said, "I saw bodies with tree stumps smashed through their chests—heads blown off—twisted arms and legs torn off by flying timber that cut like big knives." When the body parts were finally reassembled the total count was 256 veterans dead. As *Time* magazine reported, "[I]t was slaughter worse than war."

## Roosevelt Administration Takes Heat

When the news of the deadly hurricane reached Washington, many newspapers began criticizing the President and FERA. Hopkins denied responsibility, and his assistant, Aubrey Williams, called the tragedy an "act of God." The *Washington Post*, however, disagreed. "In spite of Relief Administrator Hopkins' denial that his organization was negligent in failing to evacuate the veterans on the Florida Keys, there is considerable evidence to support Governor [David] Sholtz's conclusion that 'gross carelessness somewhere' was responsible." D. W. Kennamer, whom the Veterans Administration assigned to investigate the deaths, concluded that "the only extenuating circumstance" for the failure to evacuate the veterans was Ghent's regret "that his letters to the National Emergency Relief Administration regarding this matter were unanswered."

In the search for responsibility, novelist Ernest Hemingway wrote an essay, "Who Murdered the Vets?" "[W]ho sent nearly a thousand war veterans . . . to live in frame shacks on the Florida Keys in hurricane months?" he asked. "Why were the men not evacuated on Sunday, or at latest, Monday morning, when . . . evacuation was their only possible protection?"

Neither President Roosevelt nor Harry Hopkins answered these questions.

The tragic deaths of America's hard-working veterans have almost disappeared from historical memory. Gary Dean Best's *FDR and the Bonus Marchers, 1933–1935,* is an excellent book, but it is the only one ever written on this tragedy. No U.S. history text I have ever seen even mentions the unnecessary deaths of these 256 men in a New Deal project.

This story needs to be remembered and retold. How can students make sound judgments on the proper role of government if they are sheltered from the negative unintended consequences of so many failed government programs?



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# Europe: Still a Laggard Economy

BY NORMAN BARRY

There have been increasing signs of optimism from European economy watchers. After some years in the doldrums, with slow growth and rising unemployment, things appear to be looking up: labor markets are more efficient; growth was good for 2006; and the euro is doing well against the dollar after years of weakness following its inception in 1999.

However, as I shall show, these promising signs must not be misunderstood as indications of permanent improvement, for the conditions that caused Europe's decline—rigid and inflexible markets, too-high public spending, and excessive taxation—are still there. The long-term survival of the European "social model," with its massive welfare spending, will ensure that the continent will lag behind America, much to the chagrin of the chauvinistic French. The increasing hold that the policies of European Union (EU) institutions have on the member states will guarantee that the familiar anti-market strategy will be pursued. Indeed, one method for opening up Europe's markets—the admission of former communist regimes of Eastern Europe that have pioneered low taxation and deregulation—will be weakened as they are compelled to adopt the standard inefficient European practices. The EU has never valued competition either in product markets or the markets for regulation and taxation. The most disappointing case of all is the United Kingdom: for a long period it was the least "European" of the member states and something of a free-market beacon for the continent. But under the allegedly nonsocialistic New Labor, the country has drifted toward the European "social model" while doggedly remaining outside the euro currency area.

To maintain my argument that signs of a European economic recovery are premature, I shall look at the major economies, Germany, France, Italy, and the United Kingdom, in some detail since they set the standards for the continent as a whole and illustrate its many weaknesses and few strengths. They also dominate the institutions of the EU, which are endeavoring to set common continental economic standards.

*Germany.* This is the most interesting and instructive country, for in its postwar history it has revealed both the strengths and lamentable weaknesses of European economies. It is still the world's third-biggest economy, after the United States and Japan, but seems to have lost the secret of that success. Germany's economic greatness came in the immediate postwar period when it adopted the *Sozialemarktwirtschaft* (Social Market Economy) under Finance Minister, and later Chancellor, Ludwig Erhard. It tried to combine the requisite free-market efficiency with a measure of state welfare. Thus it accepted Bismarck's welfare state but vowed it would not introduce a Scandinavian version. Welfare measures should be *marktkonform*, designed so as not to disturb the efficiency features of the free market.

But the "philosophy" of the Social Market Economy extended beyond the welfare imperative into the organization of the capitalist economy itself. Postwar Germany did not have a shareholders' economy. It included other "stakeholders," that is, non-owners who were considered to be equally important, such as trade unions and banks. Thus the two-board system of company manage-

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ment included a supervisory board with heavy union representation. Also, investment was funded not only by share issues but by bank lending. This gave the banks inordinate influence on company policy and shielded the managers from shareholder pressure; it eventually brought a loss of competitiveness to German industry. Not surprisingly, the Social Market system became popular across all political parties, including the former Marxist Social Democratic Party (SPD).

Over time the behavior of successive governments brought about the very thing the founders of the Social Market Economy did not want: a Scandinavian welfare state. Unfunded pensions were extended, as were unemployment benefits, so that it became irrational to work at all. State-funded education was generous enough to encourage students to stay at school past 30. The elimination of shareholder pressure from business protected incompetent managers—takeovers were rare and foreign acquisitions almost unheard of. A combination of all these factors led to the decline of the German economy, exacerbated by the costs of reunification, which involved the partial extension of the welfare benefits to the former communist East.

Angela Merkel

Not surprisingly, the German economy found it difficult to cope with globalization, especially with competition from the Far East. It has remained a manufacturing economy, but its rigid labor market was easily outperformed by the newly marketized China. The once-powerhouse of Europe became the weakest-growing EU economy between 1994 and 2003. When unemployment hit 5 million, over 10 percent of the workforce, even the Social Democrats realized something had to be done. Under Gerhard Schroeder they introduced mild reforms of the labor market, but they met with intense trade-union opposition. Hopes rose with the election in 2005 of the Christian Democrat Angela Merkel, who had a more radical market-oriented program. But she has been hampered by the fact that she was compelled to form a coalition with the SPD, which has representatives in the top economic positions in government.

## Not All Bad

But things are not all bad for Germany, and there has been some improvement in recent years. Economic growth has resumed, albeit falteringly, and the flow of capital to more hospitable countries has been stemmed though not stopped. Many employers' organizations are now saying that Germany is a good place to invest. While still a manufacturing economy, the proportion has fallen from almost 27 percent in 1992 to 22 percent in 2002. Much of the improvement has come about not from government's relaxation of the labor laws but rather from voluntary agreements between employers and unions. Economic reality has dented the woolly optimism of the politicians.

There is still a long way to go before Germany restores its economic greatness. Politicians could make a start by reading up on the conditions that led to Erhard's success and remembering that he was never happy with the inclusion of the word "social" in his model. And before Germans get too optimistic about their recent recovery, they should remember they face a hefty value-added-tax (a kind of European consumption tax) rise of 3 percent fairly soon—another confrontation with the reality of big government.

*France.* This is not a country that we look to for a free-market past to inspire its present and future. It is true that in the Fourth Republic the economy modernized itself, largely because no government was in power long enough to do lasting damage. De Gaulle's Fifth Republic was tied up with the Algerian problem and foreign affairs in general to either extend or foul up its basically market economy. The trouble really started with the election of François Mitterrand in 1982 and his extreme socialist program of nationalization and redistribution. Some sort of order was restored with the election of Jacques Chirac in 2000, but France remains a *dirigiste* (directed) country, whoever is in power. Today the government is still involved in banking, energy, automobiles, transport, and telecommunications. Unemployment was at 9.1 percent last July, down from 10 percent,



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but it is still a big problem, and public debt is at 6 percent of GDP, way above the mandated EU limit of 3 percent. The country is weighed down by a welfare state and a minimum wage of almost $10 per hour.

There have been some measures to address unemployment, especially among the young. These include some minor tax cuts and a serious attempt to break the rigidity of French labor laws with the "First Employment Contract" (known as CPE), which would have allowed employers with more than 20 workers to dismiss them at will for the first two years of the contract. Adequate safeguards were built in to help the "victims," but the proposed law still met with tremendous opposition from the left and the unions, no doubt fearing that something worse would follow. As a result, Prime Minister Dominique Villepin felt compelled to abandon it. That was bad news for free marketeers in France; for such a mild measure to meet with such opposition, and for the government to cave in so abjectly, indicated that France remains a socialist country even under a conservative administration.

Some other minor measures have been introduced to tackle unemployment but nothing substantive or structural. French productivity has been badly affected by the law limiting work to 35 hours per week. It was introduced allegedly to create jobs. One can almost hear the great French laissez-faire economist Frédéric Bastiat say: "Why not make it 10 hours per week. Think how many jobs that would create!"

Although there once was a radical free-market tradition in France, this is now but a distant memory. Formal Marxism might be dead, but it still casts a long shadow.

## The European Disease

France is afflicted by the European disease more than any other country. This is the illusion that wealth can be created by laws, that poverty can be solved by administrative decree, and that happiness and prosperity are a function of goodwill rather than reward for effort. Although there once was a radical free-market tradition in France, this is now but a distant memory. Formal Marxism might be dead, but it still casts a long shadow. Trade unions may be weak in the private sector, but they are still powerful in the government sector and capable of great economic damage. One might ask: how does France survive at all? Well, despite the *dirigiste* government the French workforce is educated and highly productive, and growth is picking up. But both taxation and government spending are far too high for long-term economic success. There is a big public deficit, but the idea persists that it can be dealt with by high taxes and not reduced spending.

If the government won't do anything about this nightmare, the people will. Thousands are already flocking to hated England and are taking up well-paid jobs in the equally hated City of London.

Perhaps the saddest thing about France is the lack of any serious debate about the free market. There was once a politician, Alain Madelin, who understood it. He ran for president and served in Chirac's government, but he has been mute in recent years.

*Italy.* It is always a pleasure to visit this country, and even to write about it. That legendary Italian cynicism about politics is a welcome dampener on the euphoria of the Europhiles. A prominent Italian conservative said to me last April of Silvio Berlusconi, the former conservative prime minister: "He may be a crook but he is at least he is our crook." But Italians can be a little pleased at the moment. They will record a growth rate of 6 percent for 2006, the best in years. They have a socialist government but carry on making money. They are impossible to regulate and difficult to tax.

I am sure they won't get too carried away by their current success, for trouble is just around the corner. As the Italian finance minister Tommaso Padoa-Schioppa recently said: "A recovery must last for years not just six months." And will it last? Probably not. Retail sales have recently dipped; public debt is still above the recommended EU figure; and business confidence has recently taken a knock. Moreover, there is a serious long-term problem: the emigration of its skilled workers. Graduate emigration quadrupled relative to total emigrants in the



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1990s. Economic conditions must be pretty bad for qualified people to want to leave such a wonderful country, and they will probably get worse in the future. The current growth rate is unlikely to be sustained next year, and Italians are facing serious tax rises. Like other European countries, Italy is trying to solve a government debt problem by raising taxes rather than by cutting spending.

*The United Kingdom.* It is always a puzzle to talk about Britain in the context of Europe since it is never clear that it wants to be in the EU anyway. The conservatives are definitely Euroskeptic, and some would leave the EU. The tragedy is that the country is moving in a European social-democratic direction without being proper Europeans. Some Europhiles regard the country as an outpost of hated American free-market capitalism.

How then is Britain moving in a European direction? Answer: one man—the current chancellor of the exchequer and soon-to-be prime minister Gordon Brown. Okay, he doesn't believe in old-fashioned nationalization, but he does believe in tax and spend just like the Europhiles. Since his tenure began, government spending has reached 45 percent of GDP, up from 37 percent, and taxes have gone up on 63 occasions. And still government debt is about $39 billion and threatening to go even higher—largely to pay for the 800,000 new civil servants he has hired. Brown writes articles of a Euroskeptic persuasion for the *Wall Street Journal* and takes his vacations in the United States. But that does not make him seriously pro-capitalist. Under Brown the United Kingdom has whittled away the Thatcher legacy.

## The Delusions of Europe

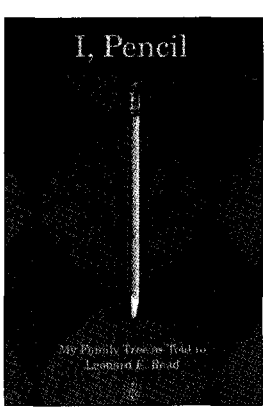
A glance at the four major economies of Europe shows that the continent is far from recovery. It is still social democratic in its outlook. Its current moderate success conceals deep problems brought about by the earlier adoption of discredited economic policies, and its only hope is to reverse the trend and follow the strategies of its new member states. I am thinking primarily of the Baltic states: Latvia, Lithuania, and Estonia. They now have flat taxes of something over 20 percent, completely privatized economies, and almost no agricultural subsidies. Therein lies the future, not in old Europe. And I have not mentioned the looming pension problem that threatens to engulf Germany, France, and Italy. Neither have I mentioned the two successful economies of old Europe, Spain and Ireland, both of which have pursued market policies. No wonder the Europhiles rarely mention them.


# *I, Pencil*

by Leonard E. Read

**Introduction *by Richard M. Ebeling***

**Afterword *by Milton Friedman***

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# Capital Letters

## Is the Income Tax Unconstitutional?

Sheldon Richman, writing in your September 2006 issue, asserts that the income tax as we know it is not unconstitutional. However, his reasoning is less than conclusive.

He cites the U.S. Supreme Court as ruling that the tax in question "is indirect and therefore does not require apportionment, only uniformity." Undeniably, he is relying upon Article I, Section 8, paragraph 1. But the requirement of uniformity is laid upon "Duties, Imposts and Excises." There is, then, no provision for any uniform tax, whether on incomes or any other transaction. The only tax that the Congress is empowered to lay and collect is that of Article I, Section 2, paragraph 3, "Representatives and direct taxes shall be apportioned . . ." this is affirmed in Article I, Section 9, paragraph 4, "No Capitation, or other direct, Tax shall be laid. . . ."

. . . One can hardly concede the author's assertion that the framers of the Constitution were less than agreed in their understanding of the word "direct"; the Articles of Confederation had given the Congress the power to tax *in*directly, that is, the taxes were collected by the States and forwarded to the Congress.

Bearing in mind that the Constitution can be amended by a mere three-fourths of the States, it is hardly plausible to suggest that the Sixteenth Amendment has authorized a tax which, far from being uniform, falls more heavily upon rich than poor States. . . .

—BRIAN W. FIRTH
*Bronxville, N.Y.*

***Sheldon Richman replies:***

My response must be brief. First, in the United States the income tax has long been regarded as an excise tax; thus it falls under the "indirect" category in the Constitution and requires uniformity not apportionment. Mr. Firth's claim that only direct and apportioned taxes may be levied is contradicted by the very constitutional provision he quoted previously about duties, imposts, and excises. It is just not the case that "There is, then, no provision for any uniform tax, whether on incomes or any other transaction."

Second, James Madison, Fisher Ames, and Alexander Hamilton could not agree on whether a tax on the possession of horse-drawn wagons was a direct or indirect tax. According to Madison's notes from the Constitutional Convention, no one responded when a delegate asked the meaning of *direct* and *indirect* as applied to taxation. It is odd to say the Articles of Confederation granted Congress the power to levy indirect taxes. It granted no power of taxation at all. That is precisely why Congress had to *ask* the states for money.

Third, the courts have held that the uniformity clause means that tax rates must be the same *state to state*. Progressive rates satisfy that requirement.

Let me repeat what I said in the article, the income tax can be constitutional without being morally legitimate. Much confusion results when we conflate these two categories.

## Is Tax Reform Really a Waste of Time?

[In his November *Freeman* article, "Sales, Flat, or Spherical, Tax Reform Isn't the Answer," Gene Callahan] compare[d] withholding and the sales tax receipt as having equal visibility.

The problem here is that the cost of government is not reflected in your pay stub. Income taxes are split from FICA taxes; FICA taxes are split between employee and employer; corporate taxes are not visible; compliance costs are not visible, etc. Under the current tax system, the federal government collects revenue through a wide variety of taxes on individuals and businesses. Thus the cost of government is spread out among many different avenues that are not fully visible to individual citizens.

In addition, your limited pay-stub view of the cost of government is based on your income and dependents claimed. Politicians use such views to play class warfare with the tax system. While I believe there is a difference



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in the government taking your money before you see it as opposed to after you have it, perhaps, as [Callahan] stated, citizens would become used to the tax "receipt." The point is that the Fair Tax receipt would show the true cost of the federal government for all citizens, including tax compliance. . . .

[Callahan further pointed out] that a business could pay for as much employee consumption as possible, avoiding the tax. To prevent businesses from purchasing everything for their employees, in a family business, for example, goods and services bought by the business for the employees that are not strictly for business use would be taxable. Health insurance or medical expenses would be an example where the business would have to pay the Fair Tax on these purchases. It is unlikely with the high potential for audits that businesses would purchase on behalf of their employees for personal consumption. . . . In order for an individual to purchase items tax-free for business purposes, the business would be required to be a registered seller with the state sales tax authority, and thereby be subject to audit. . . . Businesses would be required to submit monthly or quarterly reports (depending on sales volume) of taxable sales and sales tax collected on their monthly sales tax return. . . .

—JEFFREY GENTES
*jeffg@carolina.rr.com*

[Gene Callahan] wrote in reference to *The Fair Tax Book:* "The authors are guilty of counting the savings their readers will see from ending the income tax twice, once in the price of the things they buy and again in their own paychecks. In reality, getting rid of any tax will result in some combination of lower prices and higher incomes, the proportion depending on the particular circumstances of each case. But the total of the two effects will only sum to the gross reduction in taxation, and certainly not to double that figure!" Does anyone besides Mr. Callahan follow his logic? The untaxed price of goods will reduce under the Fair Tax as a result of (God love it!) *free enterprise.* This is a result of the elimination of taxes during the manufacturing process. The elimination of the income tax puts 100 percent of your earnings in your bank account. These are two separate issues and to convolute the two in some form of double talk is simply an effort to make it sound like a bad idea. . . .

—DOUGLAS MCCUE
*Rutherfordton, N.C.*

***Gene Callahan replies:***

In response to Mr. Gentes: In my article I admitted that the method of collection could make some difference. Nevertheless, it remains true that, just like the Fair Tax, the target of the income tax gets a receipt showing how much he has paid. People simply ignore their pay stubs, and I don't see why they wouldn't learn to take for granted their Fair Tax receipts.

As far as tax avoidance goes, my contention was not that business would be able to dodge the tax, but that it is disingenuous for Neal Boortz and John Linder to continually tout the benefits of doing away with the IRS without any discussion of how they would deal with tax compliance.

Mr. McCue has missed my point: The authors of *The Fair Tax Book* contend both that producers pass all taxes on to consumers and that the reader will have an increased income from not paying the income tax. But the reader, in terms of his income, *is* a producer! Why isn't the reader passing on the incidence of the income tax like all other producers?

We will print the most interesting and provocative letters we receive regarding articles in *The Freeman* and the issues they raise. Brevity is encouraged; longer letters may be edited because of space limitations. Address your letters to: *The Freeman*, FEE, 30 S. Broadway, Irvington-on-Hudson, NY 10533; e-mail: freeman@fee.org; fax: 914-591-8910.



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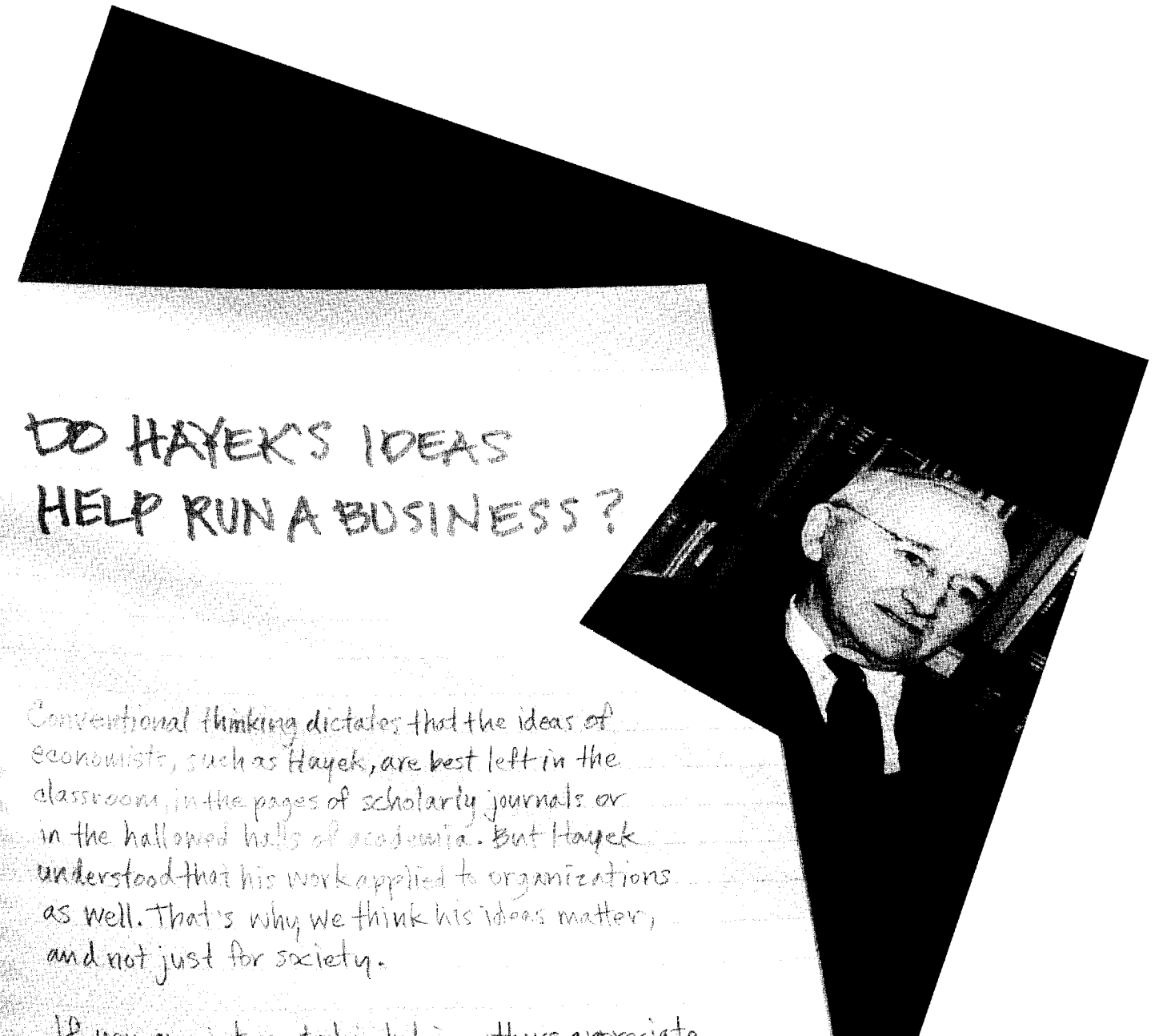
# DO HAYEK'S IDEAS HELP RUN A BUSINESS?



Conventional thinking dictates that the ideas of economists, such as Hayek, are best left in the classroom, in the pages of scholarly journals or in the hallowed halls of academia. But Hayek understood that his work applied to organizations as well. That's why we think his ideas matter, and not just for society.

If you are interested in helping others appreciate Hayek's ideas and how to apply them to create real value for society, please go to www.kochcareers.com and do a search for senior business consultant, so we can begin a dialogue.



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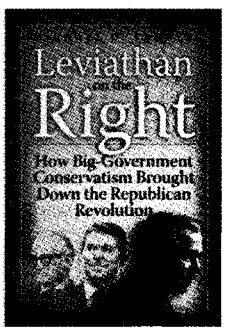
# Book Reviews

## Leviathan on the Right: How Big-Government Conservatism Brought Down the Republican Revolution

*by Michael D. Tanner*
Cato Institute • 2007 • 299 pages • $22.95

Reviewed by Richard M. Ebeling




During the first six years of the George W. Bush administration, government domestic spending has increased by 27 percent in real terms. Domestic discretionary (non-entitlement) spending has grown at a real annual rate of 4.5 percent over these six years, compared to 2.1 percent per year under Bill Clinton. Indeed, President Bush has been the biggest big spender since Lyndon Johnson and his Great Society policies of the 1960s.

Furthermore, government's intrusiveness in the social and economic life of the country has also gone up dramatically. Bush and a Republican Congress enacted the Medicare prescription-drug benefit, the largest new entitlement program since President Johnson signed the Medicare bill four decades ago. Bush also expanded the tentacles of federal control over education by pushing No Child Left Behind, which promises more and more regulation and national standards imposed by Washington. Federal spending on education has increased by more than 50 percent; the Department of Education budget has gone up from $33.6 billion in 2001 to $51.1 billion today.

A Republican Congress happily passed bill after bill that increased the spending on a pork barrel full of programs to benefit every conceivable special-interest group. The most notorious are "earmarks," which target money for particular states and designated constituents. The corruption scandals of the last few years have merely been the tip of the iceberg of a Republican congressional mentality that nothing was more important than reelection and power.

In his new book, *Leviathan on the Right*, Cato Institute policy analyst Michael D. Tanner details the degree to which the Republicans in charge of Congress from 1995 through 2006 were drawn into the vortex of political plunder and abuse. That politicians, regardless of their ideological labels, take advantage of political office is nothing new. Eighty years ago, Austrian economist Ludwig von Mises pointed out that "Even [classical] liberal politicians, on gaining power, have usually relegated their liberal principles more or less to the background. The tendency . . . to abuse political power . . . is too deeply ingrained in the mentality of those who control the government apparatus of compulsion and coercion for them ever to be able to resist it voluntarily."

What Tanner tries to explain is why the American political party that claimed to defend individual freedom and limited government over the last 70 years has seemingly turned its back on those ideas. The essence of this story is the transformation of American conservatism into what has become known as neoconservatism. Tanner points out that before World War II American conservatism was really classical liberalism. But after the war, the anti-statist movement was made up of two distinct strands of thought: libertarianism, which continued to uphold the classical-liberal banner, and a reconstructed conservatism that emphasized tradition, was suspicious of policy based on reason alone, and adhered to a religious foundation for liberty.

At the same time, however, there was slowly emerging a different brand of political thought that now bears the label "neoconservative." Its founders included Sidney Hook, Lionel Trilling, Irving Kristol, Gertrude Himmelfarb, and Daniel Bell. They had been Trotskyite Marxists who opposed Stalinism in the 1930s and 1940s. In the postwar period they concluded that Stalinism was an inescapable part of Marxism and became vocal anticommunists.

Another group, including Norman Podhoretz, Midge Decter, Harry Jaffa, Allan Bloom, Paul Wolfowitz, and Robert Kagan, were all influenced by classical philosopher Leo Strauss of the University of Chicago. Strauss believed that rationalism and liberalism had undermined the foundations of traditional Western civilization and had opened the floodgates to the barbarism of Nazism and communism. Strauss rejected classical liberalism and



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free-market capitalism because they supposedly fostered a rootless individualism and pandered to the baser material desires of man. Civilization required a renewal of the classical Greek ideals of virtue, the heroic, and the notion of a higher collective calling. The means for restoring the virtuous society was a strong government that inculcated the appropriate values among the citizenry.

Religion was essential, too, because it gave man a sense of a divine meaning to life and provided the Archimedean point to justify the belief in universal truths. But what if "God is dead"? Still, the masses must be made to believe God exists, otherwise chaos and destruction will be man's fate. If Marx had considered religion to be a harmful "opiate of the masses," the Straussians considered it a useful and necessary narcotic.

Furthermore, these two strands of modern neoconservatism were not, in principle, against the welfare state. True to their earlier socialist roots, many of them considered it the duty and responsibility of the government to provide essential "social safety nets" since these could not and should not be left to the uncertainties and amorality of blind market forces. The neoconservative critique of the welfare state, beginning in the 1960s and 1970s, was based on the idea that in its current form political paternalism undermined the ethics of family, work, and personal responsibility that are essential to social stability. What was needed was reform of the welfare state but not its repeal. The state should be used to create the "right" incentives to get people to develop the "correct" behavioral characteristics.

For these reasons, Tanner argues that modern American liberalism and neoconservatism are both ideologies of state manipulation of human conduct. Their differences merely concern a vision of the good society that activist government policy should try to create, and the regulatory and interventionist means to bring it about.

Another element of neoconservatism, represented by William Kristol and David Brooks, is what Tanner calls "national-greatness conservatives." They reject the notion that in the free society each individual should find his own purpose and meaning to life and that those who share beliefs should associate and advance their private visions through the voluntary institutions of civil society. These neoconservatives believe that Americans must be made to share and work for common national objectives to give them a sense of united community through government projects and propaganda—at taxpayers' expense, of course.

Tanner also explains how the neoconservatives have come to make common cause with the religious right in America. Even though many neoconservatives are non-Christians, indeed sometimes agnostics or atheists, they have aligned themselves with a variety of conservative Christian policies that require government restriction on free-market activities. Here we see the Straussian emphasis on the need to inculcate religious ideas, even if those who do the inculcating do not personally believe in them.

For Tanner it is not surprising that the last six years have seen such an explosion in government spending and power. Not only was this nearly inevitable when one party came to control both the executive and legislative branches of government, but it was also reinforced and indeed fostered by a neoconservative ideology that has turned its back on the traditional American conservative ideals of limited government and individual freedom. The task in the years ahead, Tanner says, is to return conservatism to its original roots and away from this neoconservative mutation.

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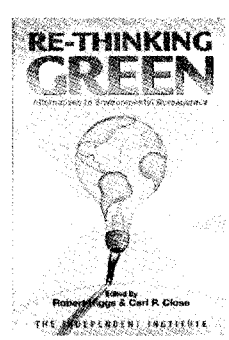
## Re-Thinking Green: Alternatives to Environmental Bureaucracy

*Edited by Robert Higgs and Carl P. Close*
Independent Institute • 2005 • 440 pages
• $22.95 paperback

Reviewed by Michael Sanera




Readers of *The Freeman* don't need to be reminded that freedom works better than coercion, but when I hike a wilderness trail I sometimes think there might be some small role for government in protecting the environment. If you're inclined to drift in that direction, *Re-Thinking Green* pro-



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vides the antidote. Robert Higgs and Carl Close have collected 22 articles that cover the gamut of environmental issues—population, global warming, endangered species, coastal management, urban planning, air pollution, and energy. The common theme is the explanation of how the good intentions of environmental groups, policy makers, and bureaucracies fail to produce improvements in the environment. Since it isn't possible to do justice to each chapter, I have chosen three examples to provide the reader a flavor of this gem of a book.

Elephants occupy a special place in most of our hearts, and they're especially appealing to children. Think of Babar and Dumbo. Environmental groups have converted many to their cause by describing in vivid detail the road to elephant extinction. As a result, the 1989 international ban on the ivory trade was celebrated as a great environmental victory. Yet this ban was passed over scientific and economic objections by leading conservationists who demonstrated that it would *harm* elephant populations. How did this harmful ban pass in the face of scientific and economic evidence?

William Kaempfer and Anton Lowenberg's article, "The Ivory Bandwagon: International Transmission of Interest-Group Politics," provides the answer. The crux of their analysis is that environmental groups observed that the "save the elephant" crusade brought in truckloads of money and busloads of new members. Therefore, leaders of those organizations turned a deaf ear to the scientific and economic evidence and joined the competition for funding and membership. All the better if elephant populations suffered—just more evidence of the need for activism.

Energy has been a national concern for decades, and when gasoline topped $3 a gallon in 2006 it became a national obsession. The media often provide the public with a melodrama featuring environmental groups protecting pristine wilderness from being despoiled by greedy, profit-hungry oil companies.

In "To Drill or Not to Drill: Let the Environmentalists Decide," Dwight Lee argues that the incentives provided by private property rights help us to solve the conflict over drilling without the good-guys-against-bad-guys melodrama. Lee notes that an environmental group such as the Audubon Society opposes drilling in the Alaska Arctic National Wildlife Refuge (ANWR) because it is publicly owned land; for Audubon, the risk of an oil spill is a cost not balanced by any benefit.

On the other hand, give the Audubon Society private property rights and its incentives and behavior change. Proof of this proposition need not rest on economic theory because the Audubon Society owns 26,000 acres in Louisiana called the Rainey Wildlife Sanctuary. This area also happens to have deposits of oil and natural gas, and the Society allows production on its property. It has concluded that an estimated $25 million in annual royalties is worth the small chance of environmental damage. Lee notes that environmentalists' "adamant verbal opposition to drilling in ANWR is a poor reflection of what they would do if they owned even a small fraction of the ANWR territory containing oil."

The lessons learned by the collapse of the Soviet and Eastern European communist systems, due in large part to the failures of central planning, is lost on advocates of "smart growth." Randal O'Toole notes in "Is Urban Planning 'Creeping Socialism'?" that our urban areas are experiencing socialist planning on a grand scale through the use of extreme forms of zoning regulation. Planners and their political allies want more power to force the rest of us to live urban lifestyles of their choosing. Smart-growth advocates press local officials to require high-density and "affordable" housing. Autos in these centrally planned smart-growth cities are nearly regulated out of existence. Limits on parking, narrow streets, and an end to new road construction are designed to increase traffic congestion and encourage (read: force) people onto public transit.

In the final analysis, smart growth is a threat to individual freedom because it's an attempt to use government coercion to reverse two great liberating trends of the twentieth century: increased individual mobility provided by inexpensive autos and the desire for increased privacy provided by larger homes and lots.

*Re-Thinking Green* is the indispensable handbook to consult the next time you need to win an environmental debate.

*Michael Sanera (msanera@johnlocke.org) is research director and local-government analyst at the John Locke Foundation in Raleigh, North Carolina. He is coauthor with Jane Shaw of* Facts, Not Fear: Teaching Children about the Environment.



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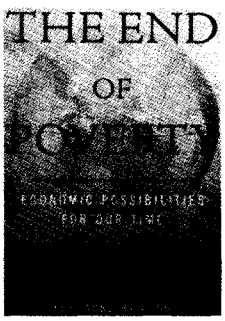
## The End of Poverty: Economic Possibilities for Our Time

*by Jeffrey D. Sachs*

Penguin Press • 2005/2006 • 396 pages • $27.95 hardcover; $16.00 paperback

Reviewed by Jude Blanchette




In the mid-nineteenth century Baptist preacher William Miller predicted the second coming of Christ on March 21, 1843, or between that date and March 21, 1844. When Christ failed to show, Miller "discovered" that the actual date of arrival was October 22 of that same year. This day came and went with nary a hint of Christ's arrival. Undeterred, Miller awaited Christ's return until his death in 1849. As Miller was to write in his memoir, "Were I to live my life over again, with the same evidence that I then had, to be honest with God and man, I should have to do as I have done."

I was reminded of this tragically comic event as I read Jeffery Sachs's *The End of Poverty: Economic Possibilities for Our Time*, a purported "blueprint" to solve global poverty. In clear, concise, and at times convincing prose, Sachs shames the world for not doing more to promote development in poor countries and argues for an increase in foreign aid to jump-start the growth process. His obdurate faith in foreign aid contradicts the majority of empirical evidence gathered over foreign aid's 60-year modern history. Undeterred, Sachs forges ahead with a flawed strategy.

Sachs uses as his blueprint the United Nations Millennium Project, which, among other things, seeks to halve the number of individuals living on less than $1 a day and reduce by two-thirds the mortality rate for those under 5 by 2015. Ambitious stuff, no doubt. After a couple of hundred pages of autobiographical ruminations, Sachs finally outlines his course for reaching these goals: money, money, money. Rich countries, writes Sachs, have consistently shorted the developing world in foreign aid. Accordingly, he called on the U.S. government and their Western counterparts to increase "Official Development Assistance" to 0.44 percent of GDP in 2006 and to 0.54 percent by 2015. Approximately $7 billion needs to be spent by 2015 on scientific research to address climate change, energy production, and health care in poor countries, Sachs writes.

For people familiar with the history of foreign aid, this simply sounds like more of the same failed policy that development "experts" have been pushing for decades. Since 1960 Africa has been the constant recipient of development aid from the West, but standards of living are no better than before. There are now several governmental and quasigovernmental agencies specifically tasked with helping lift poor countries out of poverty. The U.S. government alone has spent over $500 billion in development aid. Sadly, there's little evidence that any of these international welfare programs have done anything for sick and hungry people. As economist Peter Boone concluded, "Aid does not significantly increase investment and growth, nor benefit the poor as measured by improvements in human development indicators, but it does increase the size of government."

If foreign aid fails to bring about growth, what will? According to MIT economists Daron Acemoglu and Simon Johnson and Berkeley political scientist James Robinson, "Economic institutions encouraging economic growth emerge when political institutions allocate power to groups with interests in broad-based property rights enforcement, when they create effective constraints on power-holders, and when there are relatively few rents to be captured by power-holders." Douglass North made much the same point in his 1993 Nobel Prize lecture: "Institutions form the incentive structure of a society and the political and economic institutions, in consequence, are the underlying determinant of economic performance." In short, a constitutionally limited government that respects property rights and promotes the rule of law is the best foundation for economic growth.

Unsurprisingly, the world's poorest countries fail to provide these basic functions. Law, instead of being a tool that provides security and reliability, is arbitrary and selectively enforced. The right of property is nonexistent, and trade, often the engine of growth, is tightly controlled by the state. In much of Africa, for example, high barriers to trade are the norm. As one World Bank study found, "African tariffs are more than three times higher



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than those in the developing countries with the highest growth rates and more than five times higher than those in OECD countries."

With all the book's failings, however, the optimistic message should not be discarded. Sachs is correct that we have the tools and the knowledge to end extreme poverty. But the world's leaders—and one of its better-known economists—are not interested in the one proven recipe for economic progress. Instead of heeding Sachs's advice, policymakers would do better with that of Adam Smith, who in 1755 wrote that "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things."

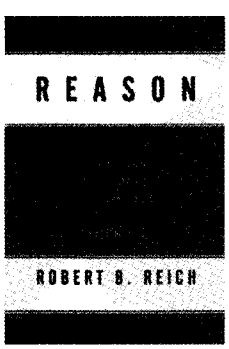
*Jude Blanchette (jblanchette1@hotmail.com) is a freelance writer.*

**Reason: Why Liberals Will Win the Battle for America**

*by Robert Reich*

Vintage • 2005 • 257 pages • $14.00 paperback

Reviewed by George C. Leef




Robert Reich, a Brandeis University law professor and former secretary of labor in the Clinton administration, fancies himself something of a public intellectual. This book offers his views on the state of affairs in America. Reich says that he's frightened by the rise to power of the broad coalition that doesn't like left-interventionist policies. He labels the entire group "Radcons" (radical conservatives), thus placing under the same imaginary tent Rush Limbaugh and Milton Friedman, Robert Bork and Ron Paul, the Moral Majority and FEE. All the Radcons, you see, have villainous designs on America, but Reich is here to save the day by exposing their ideas to the light of reason. Once people have been shown the true way—kindly "liberal" laws and regulations that help people and bring about fairness—they will abandon the Radcons and the nation will once again be safe.

That's how Reich and his publisher want people to see things, but I dissent. *Reason* has precious little reason in it. Rather than confronting Radcon positions with argumentation, Reich is content to pound away at straw men. And by painting all his opponents with a wide, coarse brush, Reich avoids confronting his most formidable adversaries—libertarians. For an intellectual, this book is an embarrassment—or should be.

First, Reich complains that Radcons have distorted "liberalism" (meaning interventionism of the FDR-LBJ sort) and have "demonized" their opponents to gain the upper hand. They win by cheating, in other words. Of course, *some* opponents of Reich's liberalism resort to language tricks. Plenty of its defenders do the same. The point Reich deliberately obscures is that many opponents of his political agenda use nothing except impeccably honest, scholarly arguments that don't distort anything. The battle of ideas has always had its hatchet men, but in a book that purports to confront the opposing case, they're irrelevant. In fact, Reich is guilty of the very thing he accuses Radcons of—trying to make easy points by demonizing those who disagree with him.

Reich's tactic of putting all his opponents in one easily sinkable boat is especially annoying. He writes that Radcons are in favor of launching preemptive wars, stifling dissent, and restricting civil liberties. That's true about some of the people Reich wants to discredit, but is he so ill informed as to be unaware that libertarians (and some conservatives) consistently oppose foreign military escapades and all laws that interfere with free speech and civil liberties?

Speaking of civil liberties, I can't resist mentioning that as secretary of labor, Reich once said that during strikes labor unions need to be able to "strap their members to the mast"—that is, prevent them from returning to work if they conclude that the strike is not in their best interest. How's that for a restriction on civil liberty? To "liberals" like Reich freedom is a good thing when they favor the result (say, opposing a war they don't like) but not when the result isn't to their liking (say, undermining "labor solidarity").

Organizations like FEE are part of Reich's rampaging Radcon horde, and he calls those of us who favor a limited state that only protects life, liberty, and property



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"free-market fundamentalists." The term is intended as a put-down, implying that we have an irrational attachment to economic liberty. You would think it child's play, then, for Reich to crush the arguments of the fundamentalists against his beloved left-interventionism. But in one of the very few instances where he deigns to mention a serious free-market thinker, Milton Friedman, here's how it goes. He quotes Friedman as saying that the trouble with governmental welfare is that it "has a bad effect on the fabric of society."

Does Reich provide a counterargument to prove that politicizing the support of the indigent actually has no harmful effects on the social fabric? No. Instead, he delivers this little pep talk to his faithful readers: "To [Friedman] and his followers, the free market has the same intoxicating quality that religion has to born-again Christians. Facts aren't especially relevant. The perfection of the market has to be accepted as a matter of faith."

That's it. No refutation, but just an inaccurate generalization pretending to be a refutation.

Reich simply won't admit that his "liberal" paradise might be flawed. Typically, he blames the defeat of Clinton's plan to take the nation into government-run health care on an evil cabal of Republican politicians who merely wanted to hand Clinton a political defeat. He never mentions the great volume of scholarly work which showed that the plan would have many bad effects.

*George Leef (georgeleef@aol.com) is book review editor of* The Freeman.


## Coming in the April issue of *The Freeman*

**Tolls on the Road to Serfdom**

by D.W. MacKenzie

**Miners, Vigilantes & Cattlemen: Property Rights on the Western Frontier**

by Andrew P. Morriss

**Visible and Invisible Hands**

by Douglas J. Den Uyl and Douglas B. Rasmussen




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# Minimum Wage, Maximum Folly

BY WALTER E. WILLIAMS

The big Associated Press story for last October 11 was that "More than 650 economists, including five winners of the Nobel Prize for economics, called Wednesday for an increase in the minimum wage, saying the value of the last increase, in 1997, has been 'fully eroded.' " Among these economists were Nobel laureates such as Kenneth Arrow of Stanford University, Lawrence Klein of the University of Pennsylvania, Robert Solow of the Massachusetts Institute of Technology, Joseph Stiglitz of Columbia University, and Clive Granger of the University of California, San Diego, who said that the real value of today's federal minimum wage is less than it has been at any time since 1951.

Their statement went on to say, "We believe that a modest increase in the minimum wage would improve the well-being of low-wage workers and would not have the adverse effects that critics have claimed." Moreover they asserted, "The minimum wage is also an important tool in fighting poverty." These and other assertions amount to what might be seen as examples of economic malpractice.

While there is a debate over the magnitude of the effects, the weight of research by academic scholars points to the conclusion that unemployment for some population groups is directly related to legal minimum wages. The unemployment effects of the minimum-wage law are felt disproportionately by nonwhites. A 1976 survey by the American Economic Association found that 90 percent of its members agreed that increasing the minimum wage raises unemployment among young and unskilled workers. It was followed by another survey, in 1990, which found that 80 percent of economists agreed with the statement that increases in the minimum wage cause unemployment among the youth and low-skilled. Furthermore, whenever one wants to find a broad consensus in almost any science, one should investigate what is said in its introductory and intermediate college textbooks. By this standard, in economics there is broad agreement that the minimum wage causes unemployment among low-skilled workers.

The reasoning for this unemployment effect is quite simple. If Congress got its way, the current minimum wage is $5.85 an hour. The hourly wage is not the only cost of hiring a worker. There are also legally mandated fringe benefits such as employer payments for Social Security, Medicare, unemployment compensation, and worker-compensation programs at federal and state levels. These mandated benefits may run as high as 30 percent of the hourly wage. This makes the minimum hourly cost borne by the employer close to $8 an hour. Put oneself in the place of an employer and ask: Does it make sense for me to hire a worker who is so unfortunate as to have skills enabling him to produce $4 worth of value per hour when he is going to cost me $8 an hour? Most employers would see doing so a losing economic proposition and not hire such a worker. Thus the minimum wage discriminates against the employment of the least-skilled workers. In our society, the least-skilled workers tend to be teenagers, particularly black teenagers.

> I am embarrassed that so many members of my profession are willing to argue that the price of something does not affect the quantity taken of it.

I am embarrassed that so many members of my profession are willing to argue that the price of something does not affect the quantity taken of it. To use the jargon of our profession, the implication of their argument

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is that the demand curve for low-skilled labor has zero elasticity. I propose a test. Ask one of the 650 economists for a yes or no answer to the question of whether the demand curve for low-skilled labor has zero elasticity, or for that matter whether any good or service has a zero-elastic demand curve. I am hoping he will say no. But if no is the answer, ask how it can be said that increases in the minimum wage have no effect. He might respond that modest increases in the minimum wage would produce little or no unemployment effect. In other words, the demand curve has zero elasticity for relatively small increases in the minimum wage. Then ask whether he knows that demand curves are more elastic in the long run. That is, while employers might not respond immediately to higher wages, in the long run they will find substitutes such as automation, change production techniques, or relocate to a lower-wage country.

The most ludicrous part of the statement by the 650 economists is "The minimum wage is also an important tool in fighting poverty." This assertion does not even pass the smell test. There are miserably poor people in the Sudan, Bangladesh, Ethiopia, and many other places around the globe. Would any of these economists propose that the solution to world poverty is a high-enough minimum wage? Whether it is Ethiopia or the United States, poverty is not so much a result of being underpaid as being underproductive. Congress can legislate that a worker be paid a certain amount. Congress cannot legislate that a worker be more productive and cannot legislate that a particular employer hire a particular worker.

There is another effect of legally mandated wages that often goes unappreciated. It can be seen in a couple of statements supporting the minimum wage. For example: "There is no job reservation left in the building industry, and in the circumstances I support the rate [minimum wage] for the job as the second best way of protecting our white artisans." "A year later," wrote G.M.E. Leistner and W.J. Breytenbach in *The Black Worker of South Africa*, "[the same person just quoted] stated that he would be prepared to allow black artisans into the industry provided that minimum wages were raised from Rand 1,40 to at least Rand 2,00 per hour and if the rate-for-the-job [equal pay for equal work] was strictly enforced."

## Preferred Tool of Racists

Both statements were made by the secretary of South Africa's avowedly racist Building Workers' Union, Gert Beetge. Why would South Africa's racist unions support minimum wages for blacks? The answer is easy. Mandated wages are one of the most effective means of pricing one's competition out of the market, and historically, mandated wages have been one of the most effective tools in the arsenal of racists everywhere. I am not arguing that those 650 fellow economists of mine have the same intentions as a racist South African union, but the intentions behind a policy may have little or nothing to do with the effects of that policy.

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My hypothesis for this otherwise inexplicable behavior is not that my fellow economists are untrained in the effects of minimum wages. My hypothesis is that they know that most workers earn more than the minimum wage. They also know that even the worker earning the minimum wage does not earn it for long. Therefore, increases in the minimum wage will negatively affect only a small portion of the workforce. Moreover, they know that not having a job does not mean starvation, at least not in America. Welfare is a substitute for not being in the job market. Thus supporting the minimum wage might be their attempt to appear compassionate. Seemingly uncompassionate people like me do not make it onto the brie, tofu, and champagne circuit.



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